No. 88-396-CFX
Status: GRANTED

Title: Colonial American Life Insurance Company, Petitioner
v.
Commissioner of Internal Revenue

Docketed:
August 22, 1988

Court: United States Court of Appeals
for the Fifth Circuit

Counsel for petitioner: Nash Jr.,Thomas G.,
Richardson,Margaret Milner

Counsel for respondent: Solicitor General

Entry	Date	Note	Proceedings and Orders
1	Aug 22 1988	G	Petition for writ of certiorari filed.
3	Oct 3 1988		Order extending time to file response to petition until November 5, 1988.
4	Oct 6 1988		Brief amici curiae of American Council of Life Insurance, et al. filed.
5	Nov 4 1988		Order further extending time to file response to petition until November 15, 1988.
6	Nov 15 1988		Brief of respondent CIR in opposition filed.
7	Nov 16 1988		DISTRIBUTED. December 2, 1988
8	Dec 5 1988		Petition GRANTED.
			**********
9	Jan 3 1989	G	Motion of petitioner to dispense with printing the joint appendix filed.
11	Jan 3 1989		Order extending time to file brief of petitioner on the merits until January 28, 1989.
12	Jan 10 1989		Record filed.
		*	Certified copy of original record and proceedings received. (Box).
13	Jan 17 1989		Motion of petitioner to dispense with printing the joint appendix GRANTED.
14	Jan 27 1989		Brief amici curiae of American Council of Life Insurance, et al. filed.
15	Jan 27 1989		Brief of petitioner Colonial American Life Insurance filed.
17	Feb 22 1989		Order extending time to file brief of respondent on the merits until March 13, 1989.
19	Mar 8 1989		SET FOR ARGUMENT, APRIL 18, 1989. (2nd CASE)
20	Mar 13 1989		Brief of respondent CIR filed.
21	Mar 28 1989		CIRCULATED.
22	Apr 11 1989	X	Reply brief of petitioner Colonial American Life Insurance Co. filed.
23	Apr 18 1989		ARGUED.

(1)

88-396

Supreme Court, U.S.
FILED
AUG 22 1988
JOSEPH F. SPANIOL, JR.
CLERK

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

The question presented on Appeal is whether the Tax Court correctly allowed Colonial American Life Insurance Company an immediate deduction or expense (in the tax year paid) of the amount paid by the company as a "ceding commission" or "initial allowance" in regard to indemnity reinsurance agreements. This pertains to accounting and tax distinctions between indemnity and assumption reinsurance set out in Internal Revenue Code Sections 806, 809, and 817 and Regulations published thereunder. The Tax Court allowed the deduction in Colonial American, 51 TCM 1123, following Beneficial Life Insurance Co., 79 T.C. 627 (1982). The Honorable Court of Appeals reversed the Tax Court holding the amounts must be amortized over the expected life of the contract and further holding that there was no distinction between the two types of reinsurance.

PARTIES IN THE CASE BELOW

The parties to this Appeal are: COLONIAL AMERICAN LIFE INSURANCE COMPANY and the COMMISSIONER OF INTERNAL REVENUE.

This appeal is taken from the U.S. Court of Appeals for the Fifth Circuit.

The Appellee — Petitioner below is Colonial American Life Insurance Company. The Commissioner of Internal Revenue is the Appellant — Respondent below.

Pursuant to Sup. Ct. R. 28.1, it is noted that Fleet Financial Group, Inc. is the parent corporation of petitioner Colonial American Life Insurance Company.

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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY

Appellant

VS.

COMMISSIONER OF INTERNAL REVENUE

Appellee

JURISDICTIONAL STATEMENT AND PETITION

OPINION BELOW

The opinion of the Tax Court is reported at 51 TCM 1123 and the opinion of the Court of Appeals is reported at 843 F. 2d. 201. A copy of the opinion is included in the appendix being filed by the Appellant.

JURISDICTION

The opinion of the United States Circuit Court, Fifth Circuit was entered on April 26, 1988 reversing the Tax Court with orders to enter Judgment consistent with the opinion. Motion for Rehearing was timely filed and was denied by order entered May 25, 1988. Notice of Appeal was filed August 16, 1988 in the United States Court of Appeals for the Fifth Circuit. This Appeal is being docketed with this Court, within the applicable time limits. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 2101 and Rules 10, 11 and 12 of the Supreme Court.

STATUTORY PROVISIONS INVOLVED

The Court of Appeals was concerned with Internal Revenue Code Sections 162, 801(a), 806(a), 809(b), (c) and (d), 817, 818(a) and 820 and Regulations issued thereunder. These are reproduced in the appendix filed herewith.

STATEMENT

Colonial, a Louisiana corporation engaged in the business of writing and reinsuring life, accident and health insurance contracts and qualified for federal income taxation as a life insurance company. In 1975 and 1976 it simultaneously entered into coinsurance and modified coinsurance agreements as reinsurer with respect to life insurance policies written by Transport Life Insurance Company (Transport). Under the 1975 coinsurance agreement, Colonial agreed to reinsure 3 percent of Transport's liabilities on a block of whole life insurance policies in return for 3 percent of future premium income from those policies. The agreement called both for initial consideration (referred to also as a ceding commission) payable by Colonial to Transport in the amount of $60,000, and for a reinsurance premium payable by Transport to Colonial in the amount of $675,762 for assuming a share of Transport's reserve liability with respect to the reinsured policies.

Under the modified coinsurance agreement, Colonial reinsured an additional 31 percent share of the same block of life insurance policies, and agreed to pay Transport an additional ceding commission of $620,000 as consideration for the right to a proportionate additional share of Transport's future income on the policies.

Effective July 1, 1976, Colonial, as reinsurer, simultaneously entered into a second pair of coinsurance and modified coinsurance agreements with Transport respecting the same block of life insurance policies. This pair of agreements followed the same general pattern as the first set. The

coinsurance agreement covered an additional 3.6 percent share of the block of policies. The agreement provided for a ceding commission of $72,000 payable by Colonial to Transport, and for a reinsurance premium of $851,398 payable by Transport to Colonial for assuming Transport's liability for the reserves attributable to this 3.6 percent share of the reinsured policies. Under the modified coinsurance agreement executed at the same time, Colonial acquired an additional 39 percent share of the block of policies, agreeing to pay Transport a ceding commission of $780,000. Once again, no reserves were shifted to taxpayer under this agreement, and, thus, no initial reinsurance premium was called for.

Under the agreements, Transport retained all the records pertaining to the subject block of policies and continued to administer the business. The agreements also provided that Transport would pay Colonial its percentage of the income from the reinsured policies under the four reinsurance agreements and Colonial would then reimburse Transport for that portion of the expenses and benefit payments attributable to Colonial's share of those policies. Additionally, Transport was to have the right to reacquire the business on a scheduled basis.

With respect to both the 1975 and 1976 modified coinsurance agreements, Colonial and Transport consented to the application of the rules for the optional tax treatment of policies reinsured as then provided by Section 820 of the Internal Revenue Code of 1954 and Section 1.820-2 of the Treasury Regulations on Income Tax. As a result of those elections, Transport's retention of the reserves applicable to Colonial's share of the reinsured policies was treated, for federal income tax purposes as being solely custodial in nature for the benefit of Colonial. Consequently, the modified coinsurance transactions were treated in the same manner as the conventional coinsurance transactions on Colonial's income tax returns for these years — i.e., as if Transport had shifted a proportionate

share of the reserves to Colonial under all four agreements and had paid over to taxpayer an amount sufficient to cover such reserves in each instance.

On its corporate income tax returns (Forms 1120L) for 1975 and 1976, Colonial recognized as income, pursuant to Code Section 809(c)(1), the gross amount of consideration received, or deemed received, from Transport for assuming liability for the indemnified policies and deducted pursuant to Section 809(d)(2) the corresponding amounts of the reserve liabilities attributable to its share of the reinsured policies under all four agreements. In addition, Colonial deducted the ceding commissions paid to Transport on these agreements ($680,000 for 1975 and $852,000 for 1976), along with the finder's fee ($13,600) for the 1975 transaction, as "other deductions" pursuant to Section 809(d)(12) of the Code.

The Commissioner disallowed the deductions for the ceding commissions based on the determination that the ceding commissions payable to Transport under those agreements were attributable to the acquisition of intangible assets (*viz*, the right to share in future premium income thereunder) and, thus, that those amounts were neither deductible nor amortizable on the theory that the intangible rights acquired had indeterminate useful lives. Alternatively, the Commissioner determined that, to the extent such intangible rights did have determinable lives, the amounts would be amortized.

Colonial thereupon petitioned the Tax Court for redetermination of the deficiencies, asserting that the Commissioner erred in disallowing the deductions it had claimed with respect to the consideration payable to Transport under the agreements in question.

The Court held, as it has in *Beneficial Life Insurance Co.* v. *Commissioner*, 79 T.C. 627 (1982), that the "gross" consideration flowing to taxpayer under the terms of the agreement (and the amount deemed to constitute such consideration under

the parties' Section 820 election) with respect to the assumption of reserves must be included in gross premiums. The Court held, however, as it also had in *Beneficial Life*, that Colonial is nevertheless entitled to an immediate deduction for such ceding commissions in the case of indemnity reinsurance transactions such as those involved here. The Tax Court recognized that such commissions would have to be amortized over the estimated life of the policies in the case of assumption reinsurance transactions, but, relying on its earlier opinion in *Beneficial Life*, ruled that ceding commissions paid to the reinsured in indemnity reinsurance transactions may be deducted in full in the year of payment as "consideration arising out of reinsurance ceded" under Section 809(c)(1) of the Internal Revenue Code.

The Commissioner appealed to the United States Court of Appeals, Fifth Circuit. The Court of Appeals reversed the Tax Court holding the amounts paid had to be amortized over the useful life of the business and could not be deducted in the year paid. It followed the opinions of the Eighth Circuit in *Modern American Life Insurance Company v. Commissioner*, 830 F. 2d 110 (8 Cir. 1987) and *Prairie States Life Insurance Company v. U.S.*, 828 F. 2d 1222 (8 Cir. 1987).

SUBSTANTIAL QUESTION PRESENTED

The Fifth Circuit, in following the Eighth Circuit is in conflict with the Tenth circuit consideration of the distinctions of assumption reinsurance and indemnity reinsurance. *Security Benefit Life Insurance Co.*, 726 F 2d 1491 (10 Cir 1984), See also conflict with the Sixth Circuit affirmation of the Tax Court in *Buckeye Union Casualty Co.*, 54 T.C. 13 affd 448 F. 2d 228 (6 cir. 1971).

The Court has also failed to apply accounting rules mandated by this Court in *Commissioner. v. Standard Life and Accident. Ins. Co.* 443 US 148 (1977).

The Seventh Circuit has affirmed the Tax Court in an opinion handed down August 11, 1988 in *Merit Life Insurance*

Co. v. Commissioner (No. 87-2129). Merit Life involved the same type of indemnity reinsurance as in Colonial; thus a precise conflict between the Circuits on this issue is created.

The Commissioner's position in this case stems from its failure to recognize the ultimate and basic nature of the reinsurance business. All insurance, whether it be the result of an individual transfer of risks between an individual and an insurance company, or the sharing of risks between two or more insurance companies, involves the purchase of insurance by the insured and the sale of insurance by the insurer. An individual buys insurance in order to transfer the mortality risk to an insurance company (which is in the business of spreading that risk over many individual lives). A consideration is charged for that transfer by the company and is paid by the individual insured. The calculation of that premium or consideration contemplates the collection of monies (premiums) and the ultimate payment of benefits. This contract recognizes a cash stream flowing from the insured to the insurer and ultimately from the insurer back to the insured or his beneficiary. The difference between the present value of the cash stream flowing to the insurance company from the insured (the premium) and the present value of the benefits (the cash stream flowing from the insurer to the insured) plus expenses, represents the present value of expected future profits on that business. The excess of amounts received from the insured over amounts paid to the insured (together with interest earnings) represents ultimately the amounts available for payment of expenses and the realization of profit. The insurer is willing to assume the risks as set out in the individual life insurance policy because it ultimately expects to realize a profit from this long term contract. In order to carry its business the insurer pays expenses made up of taxes, commissions, underwriting costs and administrative overhead, which in the first year exceeds the premium under normal circumstances. In renewal years the insurer must not only pay current expenses but recoup first year or initial costs.

Respondent does not now and has never contended that the amount expended by an insurer in selling an individual policy represents consideration expended for the realization of future profit. Respondent is bound by Sec. 818(a) I.R.C.; *Standard Life and Accident Insurance Company v. Commissioner* 433 U.S. 148 1977.

In reinsurance transactions (with the exception of what is termed assumption re-insurance) the same sale by the *insurer* to the *insured* and transfer of risk from the insured to the insurer takes place. The ceding company (the insured) seeks to buy insurance in order to transfer and spread a risk or risks. The reinsurer (the insurer) sells this service and accepts the transfer of such risks as may be called for under the contract.

This transaction may represent the transfer of risk involving one policy or a number of policies and may involve a transfer on a policy by policy basis or upon a block basis. See *Thompson, Reinsurance* 3d edition, Chapter 6. The types and usage of such contracts is varied, but they all involve the transfer of risk from the ceding company to the reinsurer for a consideration commonly called reinsurance premium or consideration.

An insurance company buys reinsurance for the same reasons that an individual buys insurance: the transfer of risk to be shared by others rather than itself. Reinsurance premiums are calculated in the same manner as individual insurance.

The reinsurer collects premiums, pays expenses, fees and benefits, and intends to have something left over for profit. The premium or consideration charged by the reinsurer is merely its measure of what is necessary in its business judgment to collect from the ceding company for carrying the risk on the policies reinsured through their expected term. This is similar in nature to a single premium charged by the reinsurer, which together with future premiums and investment earnings will ultimately cover the benefits to be paid by the reinsurer to the ceding

company and leave it with a profit. The argument of Commissioner pertaining to present value of future profits, merely involves one of the many factors involved in determining that premium.

The entire structure of sub-chapter L recognized this business fact. Property is defined by Section 817(b)(3) I.R.C. as not including insurance and annuity contracts. For that reason, the buying or selling of ~~insurance~~ contracts does not involve capital gain or loss treatment.

Assumption reinsurance, on the other hand, is treated in the code as a transaction similar to the purchase or sale of a capital asset (except that after 1958, capital gain or loss treatment is denied). Sections 806, 809(d)(7), and 817 recognize and provide special treatment for assumption reinsurance as that term is defined in the code. (Section 817(e)) The Commissioner has promulgated regulations under these statutory provisions which recognize the special treatment of assumption reinsurance and the statutory destinction between assumption reinsurance treaties and indemnity reinsurance treaties.

The Commissioner now attempts to ignore this basic destinction, and to treat all reinsurance the same. The Commissioner would argue that this statutory treatment of indemnity reinsurance creates a distortion and to correct this, would have the Court read out of the statutory language any distinction between assumption and indemnity reinsurance. The statutory language is plain and simple. It treats indemnity reinsurance and assumption reinsurance differently. Congress has spoken, The Commissioner should listen. This has been the decision of the Tax Court in the several cases set out above in which the issue has been presented. The conflict between the Circuit Courts should be resolved.

CONCLUSION

For the reasons presented above, probable jurisdiction should be noted and the Court should set the matter of plenary consideration on briefs and oral argument.

Respectfully submitted,

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CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing has been made on Counsel for the Commissioner of Internal Revenue on the 6th day of September, 1988 by mailing 3 copies thereof in an envelope, with postage prepaid, properly addressed as follows:

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COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

No. 87-4492.

United States Court of Appeals,
Fifth Circuit.

April 26, 1988.

Commissioner of Internal Revenue disallowed taxpayer reinsurer's deductions of ceding commissions incurred in particular tax years. The United States Tax Court rejected the Commissioner's disallowance of deductions, and Commissioner appealed. The Court of Appeals, Garza, Circuit Judge, held that amounts paid by reinsurer to initial insurer under contract for indemnity reinsurance for conventional and modified coinsurance, including ceding commissions and finder's fee, had to be depreciated or amortized over useful life of interest acquired, and could not be deducted in year costs were incurred.

Reversed with instructions.

Internal Revenue 3372

Amounts paid by reinsuring company to initial insurer under indemnity reinsurance contracts for conventional coinsurance and modified coinsurance, including ceding commissions and finder's fee, had to be depreciated or amortized over useful life of interest acquired, and could not be deducted in year costs were incurred. 26 U.S. C.A. § 809(c)(1), (d)(2); 26 U.S.C.(1970 Ed.) § 809(d)(12).

Appeal from the Decision of the United States Tax Court.
Before GARZA, REAVLEY and DAVIS, Circuit Judges.
GARZA, Circuit Judge.

I

Colonial American Life Insurance Company is a life insurance company that sells life, accident and health insurance. This action was brought by Colonial after the Commissioner of Internal Revenue disallowed Colonial's deductions of "ceding commissions" incurred in 1975 and 1976.[1] The Tax Court rejected the Commissioner's disallowance of Colonial's deductions, holding that amounts paid by a reinsuring company (Colonial) to an initial insurer (Transport) under a contract for indemnity reinsurance may be deducted in the year incurred and not amortized over the anticipated useful life of the policies. We are reversing the Tax Court.

Before considering the narrow tax question involved in this case, it is necessary to first understand the nature of an indemnity reinsurance contract and its relationship to other forms of reinsurance transactions. Reinsurance is an arrangement whereby an insurance company transfers some or all of the risks it has underwritten to another insurance company.[2] The company purchasing the reinsurance is known as the initial insurer, the reinsured, or the ceding company; the company acquiring the risk is known as the reinsurer or the reinsuring company.

There are basically two types of reinsurance — assumption reinsurance and indemnity reinsurance. In assumption reinsurance, the reinsuring company takes over for the initial insurer and becomes directly liable to the policyholders. The

[1]The Commissioner also sought to disallow a "finder's fee" ($13,600) paid by Colonial to Transport Life Insurance Company in 1975.

[2]An insurance company may want to reinsure its risks for a number of reasons including the diversification of its business, the acquisition of another insurance company indirectly through the acquisition of its business, the avoidance of a concentration of risk in one geographic area or line of business, and relief from the surplus drain that may occur as a result of the heavy expenses and the necessity of establishing reserves connected with newly written policies.

initial insurer is relieved of all liability, including the maintenance of the required reserves. The reinsuring company has the duty of establishing and maintaining the required reserves. In addition, the reinsuring company is entitled to all premiums paid and must pay all future claims and expenses with respect to the policies.

With respect to indemnity reinsurance, two variations are relevant here: conventional coinsurance and modified coinsurance. In an indemnity reinsurance contract the initial insurer and the reinsuring company share the benefits and obligations arising out of the reinsured policy or contract. Furthermore, the initial insurer will transfer to the reinsuring company all or part of its liability on the policies being reinsured. The initial insurer remains directly liable to the policyholders and continues to collect premiums and to pay claims and expenses. The reinsuring company will then reimburse the initial insurer for the claims and expenses attributable to the risks it has reinsured.

Conventional and modified coinsurance significantly differ in their effect on the reserves of the insurance companies involved. Essentially, reserves are liability accounts representing the present value of the company's net liabilities under the policies in force. Life insurance companies are required to maintain reserves in an amount equal to the excess of the present value of future benefits payable under the policies over the present value of future net premiums. Such liability must be backed by cash or other assets of the insurance company. In a conventional transaction, the initial insurer reduces its reserves by the amount attributable to the ceded liability. The reinsuring company will then establish reserves to cover that liability acquired. In a modified coinsurance transaction the initial insurer maintains the required reserves and merely collects and pays over to the reinsurer the investment income derived from the assets supporting the reserves.

In conventional and modified coinsurance two exchanges take place: (1) the initial insurer pays the reinsuring company full consideration for the reserve liability assumed, and (2) the reinsuring company pays the initial insurer a "ceding commission" or an "initial allowance" for the business acquired. Insurance companies typically net these transactions, with only the excess amount changing hands. Thus, the reinsuring company has income equal to the reserve liability actually assumed even though such liability exceeds the consideration actually received. This appeal centers primarily over the proper characterization of ceding commissions for the purposes of the Internal Revenue Code. In this case, the ceding company, Transport entered into both conventional and modified coinsurance agreements with the reinsuring company, Colonial.

Under the conventional agreement, Colonial agreed to reinsure three percent of Transport's liabilities on a block of whole life insurance policies in return for a three percent of future premium income from those policies. The agreement called for an initial consideration (ceding commission) in the amount of $60,000 payable to Transport for the right to receive the future income generated by the reinsured policies, and for an additional consideration (reinsurance premium) in the amount of $675,762[3] payable by Transport to Colonial for assuming a share of Transport's reserve liability with respect to the reinsured policies.

Under the modified agreement, Colonial reinsured an additional 31 percent share of the same block of life insurance policies, and agreed to pay Transport an additional ceding commission of $620,000 as consideration for the right to a proportionate share of Transport's future income of the policies. Unlike the conventional agreement, the modified agreement

[3]This figure was calculated from the conventional agreement which specifically called for payment to taxpayer in an amount equal to the new reserves attributable to the risks reinsured.

did not call for an initial reinsurance premium to cover a proportionate share of the reserves on the reinsured policies since no portion of those reserves was shifted to Colonial under this agreement. After netting the amounts payable to each party, $4,238 (without interest) was paid by Colonial to Transport on December 29, 1985. Colonial also paid a finder's fee of $13,600.

On July 1, 1976, a second pair of conventional and modified coinsurance agreements were made with Transport by Colonial as reinsurer. The conventional agreement covered an additional 3.6 percent share of the block of policies. It provided for a ceding commission of $72,000 payable to Transport by Colonial in return for a proportionate share of the future premium income from the block of policies, and a reinsurance premium of $851,398[4] was paid by Transport to Colonial for assuming Transport's liability for the reserves attributable to the 3.6 percent share of the reinsured policies.

Under the modified agreement, Colonial acquired an additional 39 percent share of the block of policies and agreed to pay consideration of $780,000 as a ceding commission to Transport for the right to a 39 percent of Transport's future premium income. No reserves were shifted to Colonial, therefore no initial reinsurance premium was required. After netting the amounts payable to each party, $602 (without interest) was paid by Colonial to Transport on October 5, 1976.

Transport retained all the records regarding the block of policies and continued to process and pay all claims. Transport was to pay Colonial its percentage of the income from the reinsured policies under the new insurance agreements and Colonial was to then reimburse Transport for that portion of the expenses and benefit payments attributable to Colonial's

[4]This figure was calculated similar to the 1975 conventional agreement in an amount equal to the mean reserves attributable to the risks reinsured.

share of those policies. Transport was also to have the right to regain the business on a scheduled basis.

In both the 1975 and 1976 modified coinsurance agreements, Colonial and Transport consented to the application of the rules for the optional tax treatment of policies reinsured as provided by section 820 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.820-2 of the Treasury Regulations on Income Tax (26 C.F.R.).[5] As a result, Transport's retention of the reserves applicable to taxpayer's share of the reinsured policies was treated for federal income tax purposes as being solely custodial for the benefit of Colonial. Consequently, the modified coinsurance transactions were treated in the same manner as the conventional coinsurance transactions on Colonial's income tax returns for these years.

Colonial on its income tax returns for 1975 and 1976, recognized as income pursuant to Code Section 809(c)(1) the gross amount of consideration received, or deemed received, from Transport for assuming liability for the indemnified policies and deducted the corresponding amounts of reserve liabilities attributable to its share of the reinsured policies under all four agreements pursuant to Section 809(d)(2). Colonial, additionally deducted the ceding commissions paid to Transport in the amounts of $680,000 for 1975 and $852,000 for 1976, along with the finder's fee of $13,600 for the year 1975, as "other deductions" pursuant to section 809(d)(12) of the Code. As a result of these transactions, Colonial reported an immediate tax loss of $693,600 for 1975 and $852,000 for 1976, which reduced its gains from operations by the corresponding amounts.

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[5]There were substantial revisions by Title II, Section 211(a) of the Deficit Reduction Act of 1984, Pub.L. No. 98-369, 98 Stat. 494, 720, but the revisions were not in effect during the years in question. Citations to the Internal Revenue Code and Treasury Regulations are from the versions that were in effect during the years in question.

The Tax Court held, as it also held in *Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627 (1982), that Colonial was entitled to an immediate deduction for such ceding commissions in the case of indemnity insurance transactions such as the ones involved here. The Tax Court did recognize that in the case of assumption reinsurance transactions, that such commissions would have to be amortized over the estimated life of the policies.

II

Colonial, as a life insurance company during the years 1975 and 1976, was taxable under sections 801 through 820 of the Internal Revenue Code. In this case, our primary concern is with the computation of the adjusted premium components of the "gain or loss from operations," under Section 809(c)(1), as affected by the ceding commissions paid by Colonial to Transport.

We have previously attempted to clarify the distinctions between the various forms of coinsurance agreements. A closer examination of the coinsurance agreements in question, reveals the modified coinsurance agreements were not pure. They were a variation in that the parties consented to treatment under Section 820 of the Code, which effectively permitted the parties to treat the modified coinsurance agreements as if they had instead entered into conventional coinsurance agreements. Although Transport retained the assets and maintained the proper reserves, Transport was deemed to have done so in a custodial capacity. Thus, for tax purposes the same shift in reserves (and assets) from Transport to Colonial is deemed to have occurred in the two modified coinsurance transactions as actually occurred in the two conventional coinsurance transactions in question. This is relevant because all four reinsurance transactions are treated as though they were conventional coinsurance transactions.

It is a fundamental rule that an amount expended to acquire an asset or economic interest, benefit or advantage with

an income producing life extending substantially beyond the current taxable year may not be expressed in the year of payment but must be depreciated or amortized over its useful life. *See Commissioner v. Idaho Power Co.*, 418 U.S. 1, 12, 94 S.Ct. 2757, 2764, 41 L.Ed.2d 535 (1974). Therefore, without a clear difference in the statute for treatment of assumption reinsurance contracts and indemnity reinsurance contracts, we must apply a "general" tax rule. We are fortunate to have had the Eighth Circuit recently decide two cases with very similar issues. *See Modern American Life Ins. Co. v. Commissioner*, 830 F.2d 110 (8th Cir.1987) (modified reinsurance agreement), and *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (8th Cir.1987) (conventional reinsurance agreement). In *Modern American*, at 114 the court held:

> Because no statutory basis exists for allowing the ceding commission to be deducted as a current expense, the court resorts to generally recognized tax principles to determine the proper treatment of this payment. These principles dictate that costs incurred in the acquisition of an economic interest with an income-producing life extending substantially beyond the taxable year may not be expensed but must be depreciated or amortized over useful life of the interest acquired.

In *Prairie States* at 1234 the court held,

> [T]axpayer may not reduce its income by treating the ceding commission either as a reduction of income under Section 809(c)(1) for 'consideration arising out of reinsurance ceded,' or as an underwriting expense deductible under Section 809(d)(12). Rather, taxpayer must amortize the commission as the cost of acquiring an income-producing asset with a useful life extending substantially beyond the current taxable year.

We believe both cases were well reasoned. As we previously stated, the Tax Court correctly identified that in the case

of an assumption reinsurance agreement, the ceding commissions would be amortized for the life of the policy. Although our case involves an indemnity reinsurance agreement, this circut has rejected an argument for allowing full deduction of the ceding commissions in an assumption reinsurance agreement with reasoning that is applicable here. *See Southwestern Life Ins. Co. v. United States*, 560 F.2d 627, 640-41, (5th Cir. 1977) *cert. denied*, 435 U.S. 995, 98 S.Ct. 1647, 56 L.Ed.2d 84 (1978).

In *Southwestern Life* at 641 we stated:

> The taxpayer's effort to equate the current deductibility of commissions paid in the life insurance industry to agents who put new policies on the books of the company with the payment of $9,800,000 for the acquisition of some 100,000 outstanding policies is not an apt comparison. Atlantic has already paid commissions to its agents for the acquisition of these same policies and the value of the policies to the taxpayer here in no way represents the cost of putting the business on the books of the company. It represents instead, an estimate of the current value to the taxpayer that is represented by having these policies on its books with the expectation of the continuing premiums to be paid in the future.

III

In conclusion, we do not read the statute to treat assumption reinsurance agreements any different than indemnity reinsurance agreement. Therefore, we are holding as the Eighth Circuit held that these ceding commissions paid, including the finder's fee, must be depreciated or amortized over the useful life of the interest acquired.[6] The Tax Court is REVERSED with orders to enter judgment consistent with this opinion.

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[6]The parties stipulated to a seven year life of the policies to be amortized on a straight line basis.

UNITED STATES TAX COURT

COLONIAL AMERICAN LIFE INSURANCE COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Docket No. 20384-83
Filed: April 1, 1987

DECISION

Pursuant to the opinion of the Court filed June 4, 1986, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is an overpayment for the taxable year 1975 in the amount of $8,659.00 ($4,659.00 of which was paid on June 15, 1976 and $4,000 of which was paid on March 15, 1976), for which amount a claim for refund could have been filed under the provisions of I.R.C. §§ 6511(c) and 6511(d)(2) on May 5, 1983, the date of the mailing of the notice of deficiency; and

That there is an overpayment for the taxable year 1976 in the amount of $51,653.62, which amount was paid on June 20, 1977, and for which amount a claim for refund could have been filed under the provisions of I.R.C. §§ 6511(c) and 6511(d)(2) on May 5, 1983, the date of the mailing of the notice of deficiency.

(Signed) LAWRENCE A. WRIGHT
Judge

Entered April 1, 1987

T.C. Memo. 1986-226

UNITED STATES TAX COURT

COLONIAL AMERICAN LIFE INSURANCE COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Docket No. 20384-83. Filed June 4, 1986.

Thomas G. Nash, Jr., for the petitioner.

Seymour I. Sherman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, *Judge:* Respondent determined deficiencies of $168,031.01 and $197,481.99 in petitioner's Federal income taxes for 1975 and 1976, respectively. After concessions by the parties, the issue remaining for decision is whether the ceding commission paid by a reinsuring company to an initial insurer under contracts for indemnity reinsurance may be deducted currently by the reinsuring company or must be amortized over the anticipated useful life of the policies reinsured.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. For purposes of clarity, the general principles concerning reinsurance are incorporated in the findings of fact.

Petitioner, Colonial American Life Insurance Company (Colonial), was incorporated in 1924 in the State of Louisiana. Its principal place of business at all relevant times was in New Orleans, Louisiana. Petitioner timely filed Federal income tax returns for the calendar years 1975 and 1976.

At all relevant times petitioner was authorized to and did engage in the insurance business in Louisiana and in numerous other states, writing various forms of life, accident, and health insurance. Petitioner's principal insurance risks during the years in controversy consisted of life contingencies originally written by it or written by other companies and reinsured by petitioner.

Reinsurance is an arrangement whereby an insurance company transfers some or all of the risks it has underwritten to another insurance company.[1] The company purchasing the reinsurance is known as the initial insurer, the reinsured, or the ceding company; the company acquiring the risk is known as the reinsurer or the reinsuring company.

There are basically two types of reinsurance — assumption reinsurance and indemnity reinsurance. In assumption reinsurance, the reinsuring company takes over for the initial insurer and becomes directly liable to the policyholders. The initial insurer is relieved of all liability, including the maintenance of the required reserves. The reinsuring company has the duty of establishing and maintaining the required reserves. In addition, the reinsuring company is entitled to all premiums paid and must pay all future claims and expenses with respect to the policies.

With respect to indemnity reinsurance, two variations are relevant here: conventional coinsurance (hereinafter "coinsurance") and modified coinsurance (hereinafter "modified coinsurance"). In contrast to assumption reinsurance, under coinsurance and modified coinsurance, the initial insurer and the reinsuring company share the benefits and obligations

[1]An insurance company may want to reinsure its risks for a number of reasons including the diversification of its business, the acquisition of another insurance company indirectly through the acquisition of its business, the avoidance of a concentration of risk in one geographic area or line of business, and relief from the surplus drain that may occur as a result of the heavy expenses and the necessity of establishing reserves connected with newly written policies.

arising out of the reinsured policy or contract. The initial insurer transfers to the reinsuring company all or part of its liability on the policies being reinsured, but it remains directly liable to the policyholders and continues to collect premiums and to pay claims and expenses. The reinsuring company must reimburse the initial insurer for the claims and expenses which are paid by the initial insurer and which are attributable to the risks it has reinsured.

Coinsurance and modified coinsurance differ, however, in their effect on the reserves of the insurance companies involved. Essentially, reserves are liability accounts representing the present value of the company's net liabilities under the policies in force. Life insurance companies are required to maintain reserves in an amount equal to the excess of the present value of future benefits payable under the policies over the present value of future net premiums. Such liability must be backed by cash or other assets of the insurance company. In a coinsurance transaction, the initial insurer reduces its reserves attributable to the ceded liability and the reinsuring company must establish reserves to cover the liability acquired. In a modified coinsurance transaction, however, the initial insurer maintains the required reserves and merely collects and pays over to the reinsurer the investment income derived from the assets supporting the reserves. Although the initial insurer does not release the reserves and underlying assets, upon the parties' consent to treatment under section 820,[2] the retention of assets and maintenance of reserves by the initial insurer are treated as custodial on behalf of the reinsuring company. Thus, for Federal tax purposes, in both coinsurance and modified coinsurance transactions, the same shift of reserves from the initial insurer to the reinsuring company takes place.

[2]All section references and reference to the "Code" are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

In coinsurance and modified coinsurance two exchanges take place: (1) the initial insurer pays the reinsuring company full consideration for the reserve liability assumed, and (2) the reinsuring company pays the initial insurer a "ceding commission" or an "initial allowance" for the business acquired. Insurance companies typically net these transactions, with only the excess amount changing hands. Thus, the reinsuring company has income equal to the reserve liability actually assumed even though such liability exceeds the consideration actually received.

In 1975, petitioner entered into two reinsurance transactions, one on a coinsurance basis and the other on a modified coinsurance basis, with respect to policies of life insurance originally written by Transport Life Insurance Company (Transport), with petitioner as the reinsuring company and Transport as the initial insurer or ceding company. Petitioner and Transport consented, with respect to the modified coinsurance transaction, to application of the rules for the optional treatment of policies reinsured therein provided by section 820 and the regulations thereunder.

The coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration or ceding commission in the amount of $60,000, and a payment by Transport to petitioner of an amount equal to the mean reserves attributable to the risks reinsured. The modified coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration in the amount of $620,000. The accounting between the two companies with respect to the foregoing transactions (excluding interest) was as follows:

	Coinsurance	Modified Coinsurance
Reserves Transferred	$ 675,762	$ -0-
Ceding Commission	60,000	620,000
Amount Due Transport	$(615,762)	$620,000

In 1976, petitioner as reinsurer and Transport as ceding company entered simultaneously into two further reinsurance transactions with respect to the same policies, which policies belonged to the same groups or blocks of policies affected by the 1975 reinsurance transactions described above. The 1976 coinsurance agreement provided for the payment of an initial consideration by petitioner to Transport of $72,000, and a payment by Transport to petitioner of an amount equal to the mean reserves attributable to the risks reinsured. The 1976 modified coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration in the amount of approximately $780,000. The accounting between the companies with respect to the foregoing transactions (excluding interest) was as follows:

	Coinsurance	Modified Coinsurance
Reserves Transferred	$ 851,398	$ -0-
Ceding Commission	72,000	780,000
Amount due Transport	$(779,398)	$780,000

During 1975, petitioner paid a "finders fee" of $13,600 with respect to its reinsurance transactions with Transport, and deducted this sum as an expense.

In his statutory notice of deficiency, respondent determined that the excess amounts of the required reserves over the cash received by petitioner[3] were attributable to the acquisition of an

[3]These amounts were determined as follows:

	Coinsurance	Modified Coinsurance	Total
1975			
Reserves required	$675,762	$620,000	
Recd. by Petitioner	615,762	-0-	
Excess	$ 60,000	$620,000	$680,000
1976			
Reserves required	$851,398	$780,000	
Recd. by Petitioner	779,398	-0-	
Excess	$ 72,000	$780,000	$852,000

intangible asset with an indeterminate useful life and were not deductible. Alternatively, respondent determined that such excess amounts were attributable to the cost of acquiring assets and must be amortized over their estimated life. He capitalized such amounts and restored them to petitioner's income, but allowed no amortization because the reasonable estimated life of those assets had not been established. He also included those amounts in the computation of petitioner's assets for the taxable years 1975 and 1976, respectively.

Respondent disallowed the deduction for the $13,600 finders fee paid by petitioner in 1975, and restored that amount as an income item and asset for said year. The basis of respondent's action was his determination that such expense was a part of the cost of the 1975 reinsurance transactions with Transport.

OPINION

The first issue is whether amounts paid by a reinsuring company to an initial insurer under a contract for indemnity reinsurance may be deducted currently or must be amortized over the anticipated useful life of the policies.

This Court addressed this question in *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627 (1982). In *Beneficial*, the taxpayer, a life insurance company, entered one assumption reinsurance transaction and seven indemnity reinsurance transactions. In each transaction, the taxpayer was the reinsuring company and received actual consideration from the initial insurer in an amount less than the reserve liability actually assumed. This Court held that, with respect to both the assumption reinsurance transaction and the indemnity reinsurance transactions, the taxpayer must include in income an amount equal to the reserve liability actually assumed. We further held that, with respect to the assumption reinsurance transaction, to the extent the assumed reserve liability exceeded the actual consideration received, such excess represented the cost of business acquired which is amortizable over the useful

life of that business. *Beneficial Life Insurance Co. v. Commissioner, supra* at 642-643. With respect to the indemnity reinsurance transactions, however, we held that to the extent the reserve liability assumed exceeded the actual consideration received, such excess represented a cost of issuing insurance which directly reduces the amount included in income. *Beneficial Life Insurance Co. v. Commissioner, supra* at 646. The Court stated that the Code itself requires different treatment of assumption reinsurance and indemnity reinsurance transactions with respect to the amounts the reinsuring company pays the initial insurer for the business acquired. The Court found that the Code treats an assumption reinsurance transaction as a sale by the initial insurer to the reinsuring company. Thus, the reinsuring company must amortize the cost of the business acquired over that business's useful life. Sec. 1.817-4(d)(2)(ii)(B), Income Tax Regs. An indemnity reinsurance transaction, however, is not treated as a sale by the initial insurer to the reinsurer, but as the initial insurer's purchase of insurance from the reinsuring company.. Reinsurance income includes the consideration received with respect to assuming another's contract liabilities, less "return premiums, and premiums and other consideration arising out of reinsurance ceded." Sec. 809(c)(1). "Return premiums" is defined in the regulations as follows:

> (ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums.

* * *

Sec. 1.809-4(a)(1)(ii), Income Tax Regs. Thus, we held in *Beneficial* that the amount the reinsuring company returns to the initial insurer as a ceding commission may be deducted from the consideration received by the reinsuring company from the initial insurer. We have reviewed the analysis set forth in *Beneficial* and we find it directly applicable to the instant case. Accordingly, we hold that the amount of the ceding commission paid by petitioner to Transport may be deducted.

Respondent argues generally that the cost to petitioner of its reinsurance transactions constitutes an investment in the nature of a capital expenditure or a deferred expense, which must be amortized over the reasonably anticipated life of each respective transaction. In *Beneficial* we responded to a similar argument and therein distinguished the acquisition of an asset from the sale of insurance. We stated:

> Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit, such is also true when an insurance company issues a single policy to an individual. Yet, the expenses relating to that policy are currently deductible. While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet, the Code treats one as the issuance of insurance and one as acquisition of an asset. That makes all the difference.

Beneficial Life Insurance Co. v. Commissioner, supra at 647-648.

In support of his position that the amounts in question must be amortized respondent relies upon *Southwestern Life Insurance Co. v. United States*, 560 F.2d 627 (5th Cir. 1977), cert. denied 435 U.S. 995 (1978). In that case the taxpayer, in purchasing the stock of another insurer, paid an amount in excess of the value of the assets of the acquired company. The Court of Appeals sustained respondent's denial of a current deduction of that excess and found that the taxpayer should

amortize that amount based on section 1.817-4(d)(2), Income Tax Regs. That section requires the reinsurer in an assumption reinsurance transaction to treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense under section 809(d)(12) and amortize such amount over the reasonably estimated life of the contracts reinsured, irrespective of the taxable year in which such amount was paid to the reinsured. According to respondent, because indemnity reinsurance is, by definition, of limited duration, there is no question but that the reinsuring company in an indemnity reinsurance transaction is entitled to amortize its cost over the useful life of the policies reinsured. He concludes that the above regulation was intended merely to assure equal treatment in assumption reinsurance transactions by clarifying the period of amortization, thereby rebutting anticipated claims that the reinsured policies have an indeterminate life and costs connected with their acquisition are, therefore, not amortizable. Furthermore, respondent contends that the above regulation was intended to establish conclusively the right of the reinsuring company in an assumption reinsurance transaction to amortize its costs, not to authorize by inference the current deduction of the ceding commission in indemnity reinsurance.

We disagree with respondent's initial assertion for the reasons set forth in support of our holding in *Beneficial*. Further, a determination as to whether the purpose of the above regulation is to assure the reinsuring company in an assumption reinsurance transaction of a right to amortization is irrelevant to our determination of the issue in this case because the transactions here in issue are indemnity reinsurance transactions, not assumption reinsurance transactions. Finally, petitioner herein does not assert entitlement to a deduction for the ceding commission paid to the initial insurer based on an inference drawn from the above regulation, but rather on the express language of section 809(c)(1).

Respondent next contends that section 809(c)(1) was misconstrued in *Beneficial*. He first argues that the "premiums

and other consideration arising out of reinsurance ceded" to be subtracted from premium income are those paid by an initial insurer to a reinsuring company and, therefore, serve to reduce the premium income of the initial insurer and not that of the reinsuring company. Respondent compares the language of section 809(d)(7) with the language of section 809(c)(1). Section 809(d)(7) provides for the deduction of "consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts * * *." Respondent asserts that the phrase "consideration arising out of reinsurance ceded" appearing in that section must be construed in the same manner as the identical phrase found in section 809(c)(1). He maintains that section 809(d)(7) provides for a deduction by the initial insurer and concludes that section 809(c)(1) also must provide for a deduction by the initial insurer. Finally, he states that the reduction allowed by section 809(c)(1) is an allowance in the case of reinsurance ceded (indemnity reinsurance, see sec. 1.809-4(a)(1)(iii), Income Tax Regs.) analogous to the deduction allowed under section 809(d)(7) in the case of assumption reinsurance.

We disagree with respondent's reading of section 809(c)(1) for the following reasons. Although we believe respondent is correct in his assertion that section 809(d)(7) provides for a deduction by the initial insurer, we do not read section 809(c)(1) so narrowly. First, although the phrase "other consideration arising out of reinsurance ceded" is found in both section 809(d)(7) and section 809(c)(1), this phrase only specifies the sum being referred to, and does not indicate who would be entitled to the deduction with respect to that sum. To find otherwise would be to read this phrase out of context.

Second, by using the phrase "consideration in respect of assuming liabilities under contracts not issued by the taxpayer," the first clause of section 809(c)(1) refers specifically to a reinsuring company. It would therefore be illogical to construe

the second clause as referring only to an initial insurer. The drafters of this section made clear their intent in the first clause; where no similar restriction is expressed in the second clause, none will be imputed.

Respondent next argues that petitioner cannot rely on the first clause of the second sentence of section 809(c)(1) as authority for its claimed deduction. That sentence states: "*Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded,* amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums." (Emphasis added.) For support, respondent turns to the legislative history of section 809(c)(1) and section 820. The first clause of the second sentence of section 809(c)(1) (emphasized above) was added to the bill that became the Life Insurance Company Income Tax Act of 1959 in connection with the addition of section 820. The purpose of the enactment of section 820 was to avoid double taxation with respect to modified coinsurance. The Senate Report discussing the provisions of this bill states that dividends to policyholders, paid with respect to the reinsured policy, are to be treated as dividends paid by the reinsurer rather than the initial insurer to the extent of reimbursement by the reinsurer to the initial insurer, while experience refunds paid by the reinsurer to the initial insurer are treated as reductions in premium income of the reinsurer and as other income received by the initial insurer thus avoiding double taxation. S. Rept. No. 291, 86th Cong., 1st Sess. (1959), 1959-2 C.B. 770, 798. Respondent correctly asserts that the first clause of the second sentence of section 809(c)(1) was enacted to prevent the treatment of experience refunds in the same manner as payment of dividends to policyholders by reinsurers. Respondent appears to argue, however, that because section 809(c)(1) was added to the Code contemporaneously with section 809, its application is limited to experience refunds. Because the amounts at issue in

the instant case and in *Beneficial* were not experience refunds, received by the reinsurer and returned to the initial insurer, respondent claims that such amounts are not within the purview of section 809(c)(1).

Return premiums are defined in the regulations as amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Sec. 1.809-4(a)(1)(ii), Income Tax Regs. Respondent's argument apparently equates "return premium" with "experience refund" in construing the return requirement of section 809(c)(1). However, the statute and the regulations specifically exclude experience refunds from the definition of return premiums. See sec. 809(c)(1); sec. 1.809-4(a)(1)(ii), Income Tax Regs. The amounts at issue in the instant case, as in *Beneficial*, were fixed by contract and were not determined by or dependent on the company's experience. Therefore, respondent's assertion that the amount paid to the initial insurer is an experience refund is incorrect. Further, although the reinsurer received only the excess of the required reserves over the initial consideration contained in the contract, respondent agrees that the full amount of the reserves was constructively realized by the reinsurer and is includable in gross income. Respondent, however, refuses to accept that the reinsurer constructively returned an amount (the ceding commission), specified in the contract, to the initial insurer. Under *Beneficial*, petitioner may reduce the gross amount received from Transport by the amount constructively returned to Transport.[4]

Finally, respondent conceded on brief that resolution of the principal issue herein would be determinative of the treatment to be accorded the finders fee of $13,600. Thus, petitioner is allowed a deduction for such amount in the year in which it was paid.

To reflect concessions of the parties and the foregoing, *Decision will be entered under Rule 155.*

[4]We recently reached the same conclusion on similar facts in *Individual Life Assurance Co. v. Commissioner*, T.C. Memo. 1986-201, and *Modern Security Life Insurance Co. v. Commissioner*, T.C. Memo. 1985-629.

IN THE

UNITED STATES COURT OF
APPEALS FOR THE FIFTH CIRCUIT

No. 87-4492

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner-Appellee,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appeal from the Decision of the
United States Tax Court

ON PETITION FOR REHEARING
MAY 25, 1988

Before GARZA, REAVLEY and DAVIS, Circuit Judges.
PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby denied.

ENTERED FOR THE COURT:

/s/ THOMAS M. REALTY
United States Circuit Judge

UNITED STATES COURT OF
APPEALS FOR THE FIFTH CIRCUIT

No. 87-4492

COLONIAL AMERICAN LIFE INSURANCE COMPANY
Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant

NOTICE OF APPEAL

TO THE HONORABLE COURT OF APPEALS:

Colonial American Life Insurance Company Petitioner-Appellee, hereby gives Notice of Appeal from the Judgment of the Honorable United States Court of Appeals, Fifth Circuit, entered in this cause April 26, 1988 and its Order of Denial of Motion for Rehearing entered May 25, 1988.

Appeal to the U.S. Supreme Court is authorized under 28 USC § 2101.

Respectfully submitted,

/s/ THOMAS G. NASH, JR.

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U.S. COURT OF APPEALS
FILED
ugust 16, 1988
Gilbert F. Ganucheau, *Clerk*

STATUTES[a-1]

Section 162(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 162(a))

SEC. 162. TRADE OR BUSINESS EXPENSES

(a) **In General.** There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including:

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Section 801(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 801(a))

SEC. 801. DEFINITION OF LIFE INSURANCE COMPANY

(a) **Life Insurance Company Defined.** For purposes of this subtitle, the term "life insurance company" means an insurance company which is engaged in the business of issuing life insurance and annuity contracts (either separately or combined with health and accident insurance), or noncancellable contracts of health and accident insurance, if:

(1) its life insurance reserves (as defined in subsection (b)), plus

[a-1] The Internal Revenue Code provisions reprinted herein were in effect during the years in controversy, *i.e.*, 1975 and 1976.

(2) unearned premiums, and unpaid losses (whether or not ascertained), on noncancellable life, health, or accident policies not included in life insurance reserves,

comprise more than 50 percent of its total reserves (as defined in subsection (c)).

Section 802(b) of the Internal Revenue Code of 1954 (26 U.S.C. § 802(b))

SEC. 802. TAX IMPOSED

(b) **Life Insurance Company Taxable Income Defined.** For purposes of this part, the term "life insurance company taxable income" means the sum of:

(1) the taxable investment income (as defined in section 804) or, if smaller, the gain from operations (as defined in section 809),

(2) if the gain from operations exceeds the taxable investment income, an amount equal to 50 percent of such excess, plus

(3) the amount subtracted from the policyholders' surplus account for the taxable year, as determined under section 815.

Section 806(a) of the Internal Revenue Code of 1954 (26 U.S.C. § 806(a))

SEC. 806. CERTAIN CHANGES IN RESERVES AND ASSETS

(a) **Adjustments to Means for Certain Transfers of Liabilities.** For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary or his delegate, the means of such reserves, and the mean of the

assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

Sections 809(b), 809(c)(1) and 809(d)(1), (2), (7) and (12) of the Internal Revenue Code of 1954 (26 U.S.C. §§ 809(b), 809(c), 809(d))

SEC. 809. IN GENERAL

(b) **Gain and Loss from Operations.**

(1) **Gain from Operations Defined.** For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

(2) **Loss from Operations Defined.** For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of:

(A) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received);

(B) the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss; and

(C) the sum of the items referred to in subsection (c).

* * *

(c) **Gross Amount.** For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) **Premiums.** The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

* * *

(d) **Deductions.** For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(1) **Death Benefits, Etc.** All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) **Increases in Certain Reserves.** The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

* * *

(7) **Assumption by Another Person of Liabilities Under Insurance, etc., Contracts.** The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

* * *

(12) **Other Deductions.** Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable

income to the extent not allowed as deductions in computing investment yield.

Section 812 of the Internal Revenue Code of 1954 (26 U.S.C. § 812))

SEC. 812. OPERATIONS LOSS DEDUCTION

(a) **Deduction Allowed.** There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of:

(1) the operations loss carryovers to such year, plus

(2) the operations loss carrybacks to such year.

For the purposes of this part, the term "operations loss deduction" means the deduction allowed by this subsection.

Section 818(a) of the Internal Revenue Act of 1954 (26 U.S.C. § 818(a))

SEC. 818. ACCOUNTING PROVISIONS

(a) **Method of Accounting.** All computations entering into the determination of the taxes imposed by this part shall be made:

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

Section 820 of the Internal Revenue Code of 1954 (26 U.S.C. § 820))

SEC. 820. OPTIONAL TREATMENT OF POLICIES REINSURED UNDER MODIFIED COINSURANCE CONTRACTS

(a) **In General.**

(1) **Treatment as Reinsured under Conventional Coinsurance Contract.** Under regulations prescribed by the Secretary or his delegate, an insurance or annuity policy reinsured under a modified coinsurance contract (as defined in subsection (b)) shall be treated, for purposes of this part (other than for purposes of section 801), as if such policy were reinsured under a conventional coinsurance contract.

(2) **Consent of Reinsured and Reinsurer.** Paragraph (1) shall apply to an insurance or annuity policy reinsured under a modified coinsurance contract only if the reinsured and reinsurer consent, in such manner as the Secretary or his delegate shall prescribe by regulations:

(A) to the application of paragraph (1) to all insurance and annuity policies reinsured under such modified coinsurance contract, and

(B) to the application of the rules provided by subsection (c) and the rules prescribed under such subsection.

Such consent, once given, may not be rescinded except with the approval of the Secretary or his delegate.

(b) **Definition of Modified Coinsurance Contract.** For purposes of this section, the term "modified coinsurance contract" means an indemnity reinsurance contract under the terms of which:

(1) a life insurance company (hereinafter referred to as "the reinsurer") agrees to indemnify another life insurance company (hereinafter referred to as "the reinsured") against a risk assumed by the reinsured under the insurance or annuity policy reinsured,

(2) the reinsured retains ownership of the assets in relation to the reserve on the policy reinsured,

(3) all or part of the gross investment income derived from such assets is paid by the reinsured to the reinsurer as a part of the consideration for the reinsurance of such policy, and

(4) the reinsurer is obligated for expenses incurred, and for Federal income taxes imposed, in respect of such gross investment income.

(c) **Special Rules.** Under regulations prescribed by the Secretary or his delegate, in applying subsection (a)(1) with respect to any insurance or annuity policy the following rules shall (to the extent not improper under the terms of the modified coinsurance contract under which such policy is reinsured) be applied in respect of the amount of such policy reinsured:

(1) **Premiums and Gross Investment Income.** The premiums (to the extent allocable to the participation of the reinsurer therein) received for the policy reinsured shall be treated as received by the reinsurer and not by the reinsured. The gross investment income (to the extent allocable to the participation of the reinsurer therein) derived from the assets in relation to the reserve on the policy reinsured shall be treated as gross investment income of the reinsurer and not of the reinsured. The gross investment income so treated shall be considered as derived proportionately from each of the various sources of gross investment income of the reinsured.

(2) **Capital Gains and Losses.** The gains and losses from sales and exchanges of capital assets, and gains and losses considered as gains and losses from sales and exchanges of capital assets, of the reinsured shall (to the extent of the participation therein by the reinsurer under the terms of the modified coinsurance contract) be treated as gains and losses from sales and exchanges of capital assets of the reinsurer and not of the reinsured.

(3) **Reserves and Assets.** The reserve on the policy reinsured shall be treated as a part of the reserves of the reinsurer and not of the reinsured, and the assets in relation to such reserve shall be treated as owned by the reinsurer and not by the reinsured.

(4) **Expenses.** The expenses (to the extent reimbursable by the insurer) incurred with respect to the policy reinsured and with respect to the assets referred to in paragraph (3) shall be treated as incurred by the reinsurer and not by the reinsured.

(5) **Dividends to Policyholders.** The dividends to policyholders paid in respect of the policy reinsured shall be treated as paid by the reinsurer and not by the reinsured. For purposes of the preceding sentence, the amount of dividends to policyholders treated as paid by the reinsurer shall be the amount paid, in respect of the policy reinsured, by the reinsurer to the reinsured as reimbursement for dividends to policyholders paid by the reinsured. This paragraph shall apply also in respect of an insurance or annuity policy reinsured under a conventional coinsurance contract.

(6) **Reimbursement for 1957 Federal Income Tax.** Any amount paid in 1958 or any subsequent year by the reinsurer to the reinsured as reimbursement for Federal income taxes imposed for a taxable year beginning in 1957 or any preceding taxable year shall not be taken into

account by the reinsured as an item under section 809(c) or by the reinsurer as a deduction under section 809(d).

(7) **Rules Prescribed by the Secretary.** Such other rules as may be prescribed by the Secretary or his delegate.

In applying the rules provided by paragraphs (1), (2), (3), (4), (5), and (6) and the rules prescribed under paragraph (7), an item shall be taken into account as income only once under subpart B and only once under subpart C by both the reinsured and the reinsurer, and an item shall be allowed as a deduction only once under subpart B and only once under subpart C to both the reinsured and the reinsurer.

TREASURY REGULATIONS

Treas. Reg. § 1.806-3 (26 C.F.R. § 1.806-3)

§ 1.806-3. CERTAIN CHANGES IN RESERVES AND ASSETS.

(a) **In General.** For purposes of part I, subchapter L, chapter 1 of the Code, section 806(a) provides that if there is a change in life insurance reserves (as defined in section 801(b)), during the taxable year, which is attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such life insurance reserves, then the means of such reserves, and the mean of the assets, shall be appropriately adjusted to reflect the amounts involved in such transfer. For example, the adjustments required under section 806(a) are applicable to transfers in which one life insurance company purchases or acquires a part or all of the business of another life insurance company under an arrangement whereby the purchaser or transferee becomes solely liable on the contracts transferred. This provision shall apply in the case of assumption reinsurance but not in the case of indemnity reinsurance or reinsurance ceded. Thus, no adjustments shall be required under section 806(a) when, in

the ordinary course of business, an indemnity reinsurance contract is entered into with another company (on a yearly renewable term basis, on a coinsurance basis, or otherwise) whereby there is a sharing of risks under one or more individual contracts. It will be necessary for each life insurance company participating in a transfer described in section 806(a) to make the adjustments required by such section. Such adjustments shall be made without regard to whether or not the transferor of the liabilities was the original insurer.

Treas. Reg. §§ 1.809-4(a)(1)(ii) and (iii) (26 C.F.R. §§ 1.809-4(a)(1)(ii) and (iii))

§ 1.809-4. GROSS AMOUNT.

(a) **Items Taken into Account.**

* * *

(1) **Premiums.**

* * *

(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all

or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a)(7)(ii) of § 1.809-5 for the definition of assumption reinsurance.

Treas. Reg. § 1.809-5(a)(7)(i), (ii) and (iii) (26 C.F.R. § 1.809-5(a)(7)(i), (ii) and (iii))

§ 1.809-5. DEDUCTIONS.

(a) **Deductions Allowed.** Section 809(d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b)(1) and (2), respectively:

* * *

(7) **Assumption by Another Person of Liabilities under Insurance, etc., Contracts.**

(i) The consideration (other than consideration arising out of reinsurance ceded as defined in paragraph (a)(1)(iii) of § 1.809-4) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto) of the taxpayer.

(ii) For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809-4).

(iii) The provisions of section 809(d)(7) and this subparagraph may be illustrated by the following example:

Example. During the taxable year 1958, T, a life insurance company, transferred a block of

insurance policies and made a payment of $50,000 to R, a life insurance company, under an arrangement whereby R became solely liable to the policyholders on the policies transferred by T. Under the provisions of section 809(d)(7) of this subparagraph, T is allowed a deduction of $50,000 for the taxable year 1958. For the treatment by R of this $50,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809-4. See section 806(a) and § 1.806-3 for the adjustments in reserves and assets to be made by T and R as a result of this transaction.

Treas. Reg §§ 1.817-4(d)(1) and (2) (26 C.F.R. §§ 1.817-4(d)(1), (2))

§ 1.817-4. SPECIAL RULES.

(d) **Certain Other Reinsurance Transactions.**

(1) For any taxable year beginning after December 31, 1958, the reinsurance of all or a part of the insurance contracts of a particular type by a life insurance company, in either a single transaction, or in a series of related transactions, occurring in any such taxable year, whereby the reinsuring company or companies assume all liabilities under such contracts, shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of sections 806(a) and 809 and the regulations thereunder. However, if in connection with a transaction described in the preceding sentence the reinsured or reinsurer transfers an asset which is a capital asset within the meaning of section 1221 (as modified by section 817(a)(2)), such transfer shall be treated as the sale or exchange of a capital asset by the transferor.

* * *

(2)(i)(ii) In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809-5) transaction, a reinsurer shall in any taxable year beginning after December 31, 1957:

(A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and

(B) Treat any such amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

(iii) For purposes of paragraph (d)(2)(ii) of this section where the reinsured transfers to the reinsurer in connection with the assumption reinsurance transaction a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer shall be treated as:

(A) Having received from the reinsured consideration in an amount equal to the net amount of the increase in the reinsurer's reserves resulting from the transaction, and

(B) Having paid the reinsured an amount for the purchase of the contracts equal to the excess of the amount of such increase in the

reinsurer's reserves over the net amount received from the reinsured.

(iv) For purposes of this subparagraph, the term "reasonably estimated life" means the period during which the contract reinsured remains in force. Such period shall be based on the facts in each case (such as age, health, and sex of the insured, type of contract reinsured, etc.) and the assuming company's experience (such as mortality, lapse rate, etc.) with similar risks.

In the
United States Court of Appeals
For the Seventh Circuit

No. 87-2129

MERIT LIFE INSURANCE COMPANY,

Petitioner-Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeal from the Decision of the
United States Tax Court.
No. 13441-78—Julian I. Jacobs, *Judge.*

ARGUED JANUARY 21, 1988—DECIDED AUGUST 11, 1988

Before CUMMINGS, WOOD, JR., *Circuit Judges*, and WILL, *Senior District Judge.**

WILL, *Senior District Judge.* This appeal involves the tax consequences of a general practice in the insurance industry called reinsurance. For any number of reasons, insurance companies transfer all or part of the risk of a block of policies, under which they are the original insurer, to another insurance company, the reinsurer, in exchange for, among other things, a commission. The original in-

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* The Honorable Hubert L. Will, Senior Judge of the United States District Court for the Northern District of Illinois, Eastern Division, is sitting by designation.

surer is known as the reinsured or ceding company and commissions paid by the reinsurer (or retained by the reinsured) are called ceding commissions. There are two general types of reinsurance: indemnity and assumption. At issue is the tax treatment for ceding commissions in indemnity reinsurance transactions.

In indemnity reinsurance, the ceding company does not relinquish any of its contractual interest in the policies it issued and remains directly liable to the policy holders. No relationship, contractual or otherwise, exists between the reinsurer and the policy holders. The ceding company pays the reinsurer a percentage of the premiums it received, upon issuance of the policies, proportional to the risk assumed by the reinsurer, which may be part or all of the total risk. The ceding company continues to pay claims and expenses and collect premiums, and pays the reinsurer a percentage of the future premiums again based on the risk transferred. In exchange, the reinsuring company reimburses (indemnifies) the ceding company for its share of the claims and expenses attributable to the risk reinsured and pays (or the ceding company retains) a ceding commission.

State laws and regulations require that an insurance company maintain a reserve, in cash or other assets, reflected as a liability for accounting purposes, representing the excess of the present value of future benefits payable under the life insurance policy over the present value of future net premiums received. The amount of the reserve changes over the life of a policy and the reserve may not be used for other corporate purposes, such as distributing dividends to shareholders. However, the reserve may be invested to produce interest income. Indemnity reinsurance reduces the reserve required of the ceding company and increases the reserve required of the reinsurer, based on the proportion of the risk transferred to the reinsurer.[1]

[1] The indemnity reinsurance described above is specifically known as conventional indemnity reinsurance. There is another type of

(Footnote continued on following page)

In contrast, assumption reinsurance involves the purchase of a block of insurance policies by the reinsurer from the original insurer at which point the reinsurer assumes *all* of the original insurer's risks and obligations and becomes directly liable to the policy holders. The original insurer is then relieved of all liability under the policies and the policy holders are informed that henceforth they are insured by the reinsuring company and all future premiums are to be paid and claims made to the reinsurer. The reinsurer pays all future claims, commissions, expenses and taxes. In addition, the reinsurer assumes the entire reserve liability, thereby reducing the ceding company's reserve liability. The purchase price is normally greater than but includes a commission to the selling company. The reinsurer simply purchases the policies and steps into the shoes of the ceding or selling company.

This case involves indemnity reinsurance. Merit Life Insurance Company ("Merit"), petitioner-appellee, an Indiana corporation, reinsured (agreed to indemnify) specified percentages, but not 100%, of five blocks of insurance policies, four of which were originally insured by American General Life Insurance Company of Delaware and one by American General Life Insurance Company of New York (both original insurers are hereinafter referred to as "American General"). American General paid "reinsurance premiums" to Merit, in an amount equal to the reserves Merit was

[1] *continued*
indemnity reinsurance called modified coinsurance in which the ceding company continues to hold the entire reserve, but pays the reinsurer any investment income attributable to the assets supporting the reserve. The two companies, however, may consent, pursuant to 26 U.S.C. § 820(a), to have the tax consequences for each company be the same as if the reinsurer was maintaining the reserve in the case of conventional indemnity reinsurance. In effect, the reinsured maintains the reserve as a custodian on behalf of the reinsurer.

required to carry on the policies less ceding commissions payable by Merit to American General.[2]

In addition, under the terms of the contracts, American General agreed to transfer a specified percentage of the gross premiums thereafter received on the reinsured policies and Merit agreed to pay American General for its share of commissions, premium taxes and other expenses incurred by American General. Finally, each contract provided that American General could recapture the reinsured policies on specific dates.

During the tax years in question, 1973-75, Merit claimed a tax loss, under 26 U.S.C. § 809(b) (section 809(b) of "the Code"),[3] on each of the indemnity reinsurance contracts because the reserves required and expenses incurred with respect to each contract exceeded the reinsurance premiums Merit received from American General. Specifically, Merit recognized as gross income the consideration (reinsurance premiums) deemed received from American

[2] Two of the five reinsurance transactions at issue here are modified coinsurance transactions but Merit and American General employed section 820(a) for tax purposes. Consequently, the same tax result applies as if all five transactions were conventional indemnity reinsurance transactions, and, for convenience, we will refer to all five as indemnity reinsurance transactions.

One of the three conventional coinsurance agreements specified that American General agreed to pay Merit a reinsurance premium equal to the reserve liability on the block of policies and Merit in turn agreed to pay a ceding commission which American General offset against the reinsurance premium. The other two conventional coinsurance agreements only provide for the payment of a reinsurance premium. It is understood, however, that the reinsurance premium with respect to these two agreements represents the reserve liability less a ceding commission. Thus, all five transactions are treated as conventional indemnity reinsurance transactions which result in an actual money transfer from American General to Merit of a reinsurance premium less a ceding commission.

[3] The years in issue are governed by the Internal Revenue Code of 1954 and the Life Insurance Company Income Tax Act of 1959, 26 U.S.C. §§ 801-820.

General for assuming reserve liabilities, pursuant to section 809(c)(1), and deducted the same amount as the reserve liability, pursuant to section 809(d)(2). Merit also deducted the ceding commissions paid to (or retained by) American General from its gross premiums (gross income), pursuant to section 809(c)(1).[4] Since these amounts exceeded the gross premiums, Merit reported a loss for the transactions which it used to offset gains from other operations during those years.

The Commissioner of Internal Revenue ("Commissioner"), respondent-appellant, found deficiencies in Merit's declared federal income taxes based on Merit's *current* deduction of all the ceding commissions in the tax years in which it issued the indemnity reinsurance.[5] The Commissioner determined that the ceding commissions must be *amortized* over the anticipated lives of the reinsurance contracts (between 57 and 64 months) because, according to the Commissioner, the reinsurance contracts are intangible assets with useful lives or more than one year.[6]

[4] Section 809 provides the following in relevant part:

(c) (1) *Premiums.*—The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto), *less return premiums, and premiums and other consideration arising out of reinsurance ceded.* . . .

(d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(2) *Increase in certain reserves.*—The net increase in reserves which is required . . . .

26 U.S.C. § 809 (emphasis added).

[5] The Commissioner also found a deficiency in Merit's 1972 tax return. The issues with respect to 1972, however, were settled and are not before us.

[6] Under the contracts between Merit and American General, American General had the right to reacquire the insurance business on a scheduled basis, ranging from 57 to 64 months after the issuance of the reinsurance.

Merit petitioned the United States Tax Court for a redetermination of the deficiencies. The case was submitted to the Tax Court without a trial and resolved based on the parties' stipulated facts and exhibits. The Tax Court, relying on its earlier opinion in *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627 (1982), reversed the Commissioner and held that in indemnity reinsurance arrangements the ceding commissions are deductible in full in the year in which the indemnity reinsurance is issued. *Merit Life Insurance Company v. Commissioner of Internal Revenue*, 52 T.C.M. (CCH) 638 (1987).

The Tax Court reaffirmed its view that an indemnity reinsurance transaction is not the purchase of an asset, but rather the sale of insurance by the reinsuring company to the ceding company. Accordingly, the Tax Court, as it had in *Beneficial Life*, viewed the ceding commissions paid by the reinsuring company (or retained by the reinsured) as analogous to currently deductible underwriting expenses such as agents' commissions paid by an original insurer on the issuance of a policy and reversed the Commissioner's disallowance of their deduction. The Commissioner appeals the Tax Court's ruling. We affirm.

Standard Of Review

As noted above, the Tax Court's decision was based on stipulated facts and exhibits. The court's holding that the ceding commissions in an indemnity reinsurance transaction are immediately deductible, based on uncontested facts, is a conclusion of law. Accordingly, we review the record *de novo*. *United Fire Insurance Company v. Commissioner of Internal Revenue*, 768 F.2d 164, 167 (7th Cir. 1985). *See also Vukasovich, Inc. v. Commissioner of Internal Revenue*, 790 F.2d 1409, 1413 (9th Cir. 1986) ("A general rule of special deference to the Tax Court is inappropriate although its judgments in its field of expertise are always accorded a presumption that they correctly apply the law."); 26 U.S.C. § 7482(a) (1982).

Analysis

The Commissioner asked the Tax Court and now asks us to reconsider *Beneficial Life*. The Tax Court in *Beneficial Life* distinguished indemnity reinsurance from assumption reinsurance by deeming the former to be the "issuance of insurance," for which ceding commissions are immediately deductible, and the latter to be the "acquisition of an asset," for which ceding commissions must be amortized. 79 T.C. at 648. The Commissioner acknowledges that the distinction between assumption and indemnity reinsurance is significant to the policy holders and the ceding company but argues that it does not alter the reinsurer's position and should not create distinct tax consequences. According to the Commissioner, in both cases the reinsurer pays consideration (ceding commissions) for the right to receive future profits (reinsurance premiums) and, following the tax principle of matching expenses incurred (year by year) with income generated, *see Commissioner v. Idaho Power Co.*, 418 U.S. 1, 12 (1974), the consideration must be amortized.

Merit argues that indemnity and assumption reinsurance are different and must be treated differently for tax purposes. It points out that the Code specifically treats both differently and the Tax Court recognized this in *Beneficial Life*. Although this distinction may not achieve a direct matching of income and expenses for tax purposes, the Code and treasury regulations provide for it. The same is true, it should be noted, as to the deduction of all commissions paid on the sale of insurance.

The court in *Beneficial Life* specifically rejected the Commissioner's argument that ceding commissions in indemnity reinsurance transactions must be amortized:

> Respondent [Commissioner] cites to us numerous cases which required capitalization and amortization of acquisition expenses. However, such cases apply when an asset is acquired, not when insurance is sold. Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit,

such is also true when an insurance company issues a single policy to an individual. Yet, the expenses related to that policy are currently deductible. While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. *In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet the Code treats one as the issuance of insurance and one as acquisition of an asset. That makes all the difference.*

79 T.C. at 647-48 (emphasis added).

The Tax Court's reasoning in *Beneficial Life* is supported by the explicit language in section 809(c)(1) and the applicable treasury regulations. Section 809(c)(1) provides that an insurance company's gross income equals "the gross amount of premiums and other consideration . . . less return premiums, and premiums and other consideration arising out of reinsurance ceded." *See* note 4 *supra*. Under section 809(c)(1), "reinsurance ceded" includes commissions from indemnity reinsurance transactions but not from assumption reinsurance transactions.

> (iii) For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. *Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions.* See paragraph (a)(7)(ii) or section 1.809-5 for the definition of assumption reinsurance.

Treas. Reg. § 1.809-4(a)(1)(iii) (emphasis added).

> (ii) For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. *Such term does not include indemnity reinsurance* or reinsurance ceded (as defined in paragraph (a)(1)(iii) or section 1.809-4).

Treas. Reg. § 1.809-5(a)(7)(ii) (emphasis added). *See also* S. Rep. No. 291, 86th Cong., 1st Sess., at 54 (1959), *reprinted in* 1959 U.S. Code Cong. & Ad. News 1575; 1959-2 C.B. 770, 809. In contrast, ceding commissions paid in an assumption reinsurance transaction must be amortized:

> (2)(ii) In connection with an assumption reinsurance . . . transaction, a reinsurer shall . . .
>
> (B) Treat any amount paid to the reinsured for the purchase of such contracts, . . . , as a deferred expense that may be amortized over the reasonably estimated life . . . of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

Treas. Reg. § 1.817-4(d)(2)(ii)(B).

The Commissioner contends that "reinsurance ceded" under section 809(c)(1) refers only to the reinsured or ceding company and not to the reinsurer. There is no provision, however, in section 809 of the applicable treasury regulations which even remotely suggests the Commissioner's interpretation or distinction. In addition, the term "return premiums" is defined in the regulations as follows:

> (ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. *Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums* . . . .

Treas. Reg. § 1.809-4(a)(1)(ii) (emphasis added). Moreover, section 809(c)(1) provides for a *deduction* of ceding commissions from gross premiums earned. A ceding company *adds* ceding commissions to gross income. For the ceding company, ceding commissions represent income, not expenses (which are deducted). On the other hand, for the reinsuring company, indemnity reinsurance ceding commissions represent a current expenses which would normally be deductible as are commissions paid to a salesperson upon the sale of a policy or when premiums are received in subsequent years. *Beneficial Life*, 79 T.C. at 646.

The Court of Appeals for the Fifth Circuit, in an opinion decided after the oral argument in our case, adopted the Commissioner's position that ceding commissions in indemnity reinsurance contracts must be amortized over the anticipated life of the reinsurance contract.[7] *Colonial American Life Insurance Company v. Commissioner*, 843 F.2d 201 (5th Cir. 1988). The Fifth Circuit held that "without a clear difference in the statute [Code] for treatment of assumption reinsurance contracts and indemnity reinsurance contracts, we must apply [the] 'general' tax rule" which matches income and expenses such that expenses incurred to acquire a capital asset (in general, one with a useful life greater than one year) must be amortized over the expected life of the asset. 843 F.2d at 204. The Fifth Circuit embraced the Eighth Circuit's reasoning in *Modern American Life Insurance Co. v. Commissioner*, 818 F.2d 1386 (8th Cir. 1987) and *Prairie States Life Insurance Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987).

The Court of Appeals for the Eighth Circuit in *Modern American* held that ceding commissions in modified coinsurance transactions, where no section 820 election is made, *see* note 1 *supra*, reflect acquisition costs of capital assets which must be amortized. The *Modern American* court, however, distinguished the contract at issue there from the modified coinsurance transactions at issue in *Beneficial Life*, in which section 820 elections were made. 818 F.2d at 1389. ("The facts of *Beneficial Life* are therefore not before us, and thus we express no opinion as to the correctness of the result in that case.").[8]

[7] The contracts at issue in *Colonial American* involved both conventional and modified indemnity reinsurance transactions but, as in our case, the parties consented to the optional tax treatment under section 820(a) with respect to their modified indemnity reinsurance transactions and, thus, the reinsurance transactions presented there are the same as those in our case.

Merit argues that this distinction renders *Modern American* irrelevant to our case. In response, the Commissioner argues that, notwithstanding the Eighth Circuit's statement to the contrary, a section 820 election has no bearing on the tax treatment of ceding commissions. Because a section 820 election was made in our case, we need not express an opinion on the distinction, if any, between modified indemnity reinsurance transactions where a section 820 election is not made and a modified indemnity reinsurance transaction where a section 820 election is made, with respect to the tax treatment of ceding commissions.

The Eighth Circuit in *Prairie States* was presented with conventional indemnity reinsurance contracts and the court found no distinction between modified indemnity reinsurance where no section 820 election is made (the facts in *Modern American*) and conventional reinsurance with respect to the tax treatment of ceding commissions. More importantly, the court equated conventional reinsurance with assumption reinsurance and reasoned that both involve the acquisition of a capital asset and because ceding commissions must be amortized in assumption (purchase) reinsurance transactions, ceding commissions must also be amortized in indemnity (non-purchase) reinsurance transactions.

[8] *Beneficial Life* also involved conventional indemnity reinsurance and assumption reinsurance transactions.

It makes no difference that in this transaction, unlike the one in *Modern American*, there is income from which taxpayer could in theory deduct the commission as a 'return premium.' The real issue, and the one decided in *Modern American* with respect to modified coinsurance, is whether Section 809(c)(1) should be read to permit taxpayer to treat as an immediate reduction of income during the taxable year the cost of acquiring in a conventional coinsurance arrangement an intangible asset 'with an income-producing life extending substantially beyond the taxable year.' [*Modern American*, 830 F.2d] at 114. We hold that Section 809(c)(1) should not be so read.

* * * * *

[W]e do not believe that Congress intended to treat a ceding commission of the kind here at issue as a currently deductible underwriting expense analogous to an agent's commission paid by a direct insurer. . . . [T]he commission represents a one-time payment for the acquisition of an economic interest in a block of previously issued policies.

828 F.2d at 1233-34.

The Commissioner and the Courts of Appeals for the Fifth and Eighth Circuits fail to recognize the inherent distinctions between assumption and indemnity reinsurance transactions and the legal distinctions provided by the Code and the treasury regulations cited above. From the reinsuring company's perspective, indemnity reinsurance is not an acquisition of an intangible asset with a useful life of more than one year. By its nature, an indemnity reinsurance transaction is, from the perspective of the reinsurer, simply an indemnity or co-insurance arrangement, in substance, the sale of an insurance policy by the reinsurer to the ceding company. Economically, it is substantially the same as the sale of any other policy. In contrast, assumption reinsurance is by its nature the purchase of already issued insurance policies and the elimination of any participation or interest of the selling or ceding company.

The improper characterization of indemnity reinsurance transactions by the Fifth and Eighth Circuits and the Commissioner contributed to their misunderstanding and misinterpretation of the Code and application of the treasury regulations. In addition to embracing the Eighth Circuit's reasoning in *Modern American* and *Prairie States*, the Fifth Circuit in *Colonial American* also adopted the same rationale for indemnity reinsurance transactions as it had previously for assumption reinsurance transactions. 843 F.2d at 205, *citing Southwestern Life Ins. Co. v. United States*, 560 F.2d 627, 640-41 (5th Cir. 1977), *cert. denied*, 435 U.S. 995 (1978).

Interestingly, the Fifth Circuit in *Southwestern Life* held that "equat[ing] the current deductibility of commissions paid in the life insurance industry to agents who put new policies on the books of the company with the payment of $9,800,000 for the acquisition of some 100,000 outstanding policies is not an apt comparison." 560 F.2d at 641. That reasoning is, of course, consistent with the distinctions made by the Code and recognized and applied in *Beneficial Life* to assumption reinsurance, the type of reinsurance before the court in *Southwestern Life*. It does not follow, however, that the cost of acquiring already existing insurance policies, as in the case of assumption reinsurance, should be equated with the expenses incurred in what amounts to the sale of new insurance policies, as in the case of indemnity reinsurance. Moreover, the Code, treasury regulations and legislative history recognize that indemnity reinsurance and assumption reinsurance are to be treated differently with respect to the tax treatment of ceding commissions paid.

The Eighth Circuit also equated indemnity reinsurance with assumption reinsurance, even after recognizing that the Code and treasury regulations distinguish between the two transactions. Indeed, after noting that assumption reinsurance is "explicitly governed by Treas. Reg. § 1.817-4(d)," the court in *Prairie States* claimed that section 1.817-4(d)(2)(iii) "specifically covers transactions *similar* to the one in this case, 'where the reinsured transfers

to the reinsurer in connection with [an] *assumption reinsurance transaction* a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction." 828 F.2d at 1230 (emphasis added). While there is some similarity between assumption and indemnity reinsurance, the differences substantially outweigh the similarities and to equate the tax treatment of the two transactions based on their similarities is improper, especially in light of the fact that section 1.817-4(d)(2)(iii) applies specifically only to assumption reinsurance.

The court in *Prairie States* later acknowledged that section 1.817-4(d)(2)(ii) "by its terms applies only to assumption reinsurance transactions. Moreover, the definition of assumption reinsurance, contained in Treas. Reg. § 1.809-5(a)(7)(ii), specifically excludes indemnity reinsurance." 828 F.2d at 1232. Notwithstanding, the court found that the "principles" behind the tax provisions for assumption reinsurance (illustrated in the treasury regulations), should also control the tax treatment of ceding commissions in indemnity reinsurance transactions. *Id.* We disagree.

The current deduction of agents' commissions by *direct insurers* is provided for in the Code. In addition, the legislative history surrounding the Deficit Reduction Act of 1984 ("DEFRA"), although not controlling, recognized and strengthened this provision.

> The change [DEFRA] from present law [1959 Act] was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).

H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. 2, at 1428 (1984), *reprinted in* 1984 U.S. Code Cong. & Admin. News 697, 1073; Senate Comm. On Finance, S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess., at 555 (1984). Because substantively indemnity reinsurance is the sale of insurance by the reinsurer to the ceding company, it follows that, in addition to the explicit provisions of the Code and treasury regulations, the principles governing the sale of insurance, in the case of direct insurers, also apply to indemnity reinsurers.

Merit argues that reinsurance is just what it sounds like: insured insurance. Whether or not an insurance company sells insurance to an individual or to another insurance company, each involves the issuance of new policies and the transfer of a risk and, under the Code, the commission expenses incurred in either transaction, whether paid to insurance agents in the case of individual policies or to ceding companies in the case of reinsurance, are deductible in the year of their payment. The Commissioner does not dispute that commissions paid to agents in connection with the sale of individual insurance policies by an original insurer are currently deductible in the year of the transaction.

The Court of Appeals for the Ninth Circuit recently distinguished assumption reinsurance from indemnity reinsurance with respect to the tax treatment of ceding commissions. *Oxford Life Insurance Company v. United States*, 790 F.2d 1370 (9th Cir. 1986). Although that case involved assumption reinsurance, the court emphasized its holding by making the following comparison between both reinsurance transactions:

> Assumption reinsurance transactions receive different treatment in the Tax Code from that accorded indemnity reinsurance transactions because of the transfer of assets. An assumption reinsurance transaction is treated as a sale of policies; an indemnity reinsurance transaction is the purchase of insurance protection [by] the reinsured. *Beneficial Life*, 79 T.C. at 645-46.
>
> • • • • •
>
> The exception created in the statute for 'reinsurance ceded' specifically refers to indemnity reinsurance. Treas. Reg. § 1.809-4(a)(1)(iii); S. Rep. No. 291,

> 86th Cong., 1st Sess. at 54 (1959-2 Cum.Bull. 809). Thus, indemnity reinsurers may subtract from income any consideration returned to the ceding company with respect to the reinsurance ceded. *Beneficial Life*, 79 T.C. at 646. . . . While the [treasury] regulation notes that the definition of return premiums is specifically broadened in the case of indemnity reinsurers, *see* Treas. Reg. §§ 1.809-4(a)(1)(ii) and (iii), assumption reinsurers, as noted earlier, receive different treatment in the tax code. *See Beneficial Life*, 79 T.C. at 646-47.

790 F.2d at 1376. In addition to those provisions of the Code cited above, other provisions draw distinctions between indemnity and assumption reinsurance. *See* 26 U.S.C. §§ 806,[9] and 809(d)(7).[10]

The Court of Appeals for the Second Circuit has affirmed the Tax Court's ruling concerning a life insurance company's deductions under section 809(d)(5) for increases in reserves for "certain nonparticipating contracts." *Cologne Life Reinsurance Co. v. Commissioner*, 80 T.C. 859 (1983), *aff'd by summary order*, 732 F.2d 141 (2nd Cir. 1984) (un-

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[9] 26 U.S.C. § 806(a) provides in relevant part:

> . . . if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, . . . , the means of such reserves, and the means of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.

[10] Section 809(d)(7) provides the following in relevant part:

> (d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:
>
> (7) *Assumption By Another Person Of Liabilities Under Insurance, Etc., Contracts.*—The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

published opinion). Although dicta, the Tax Court in *Cologne* began its discussion by distinguishing between assumption and indemnity reinsurance transactions. 80 T.C. at 862 ("[T]he issuance of indemnity life reinsurance is treated generally as the issuance of life insurance."), *citing Beneficial Life*, 79 T.C. at 647-48.

Congressional history supports the similar tax treatment for indemnity reinsurance and directly-written insurance contracts, with respect to the deduction of expenses (and consequently a dissimilar tax treatment than for assumption reinsurance):

> Modified coinsurance is a form of indemnity reinsurance (as contrasted to assumption reinsurance) to indemnify an insurer against a risk it has assumed. . . . Three forms of this indemnity reinsurance have been developed. The first of these, called coinsurance, calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that *the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly*. Any expenses incurred by the initial insurer with respect to the policy are reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems.

S. Rep. No. 291, 86th Cong., 1st Sess., at 38-39 (1959), *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1959-2 C.B. 770, 797-798 (emphasis added). Had Merit acted as the original insurer with respect to the policies in these contracts, rather than as a reinsurer, it would have incurred an underwriting loss because the reserves required and expenses incurred generally exceeded the premiums received during the year the insurance was issued. Brief of *Amici Curiae* at 5.

In addition, legislative descriptions of recent revisions to the Code, although not controlling here, are indicative of the distinctions between indemnity and assumption reinsurance.

> Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, at 633 (Dec. 31, 1984). This explanation is verbatim from a Technical Advice Memorandum prepared by the Commissioner just prior to the Commissioner's appeal in this case. Tech. Adv. Mem. 87-42-004 (June 30, 1987). *See* Brief of *Amici Curiae* at n. 13.

Finally, the Commissioner claims that generally accepted accounting principles ("GAAP") hold that ceding commissions in indemnity reinsurance transactions should be amortized as an acquisition expense and, thus, tax accounting should employ the same treatment. Respondent-Appellant's Brief at n. 22.[11] The difficulty with that contention is that GAAP would only control the deduction of ceding commissions if the Commissioner's basic assumption were correct: that *indemnity reinsurance* transactions represent the acquisition of a capital asset. That assumption is, however, erroneous.

In addition, the Supreme Court has expressed a preference for the accounting rules and procedures of the National Association of Insurance Companies ("NAIC"). The Court has interpreted 26 U.S.C. § 818(a) as providing that the tax liability for insurance companies is to be com-

[11] Treas. Reg. § 1.461-1(a)(2) provides:

> (2) *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred.

puted consistent with the NAIC's rules except where "accrual accounting dictate[s] a contrary result, . . ." *Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148, 159 (1977).[12] Because generally accepted accounting principles (accrual accounting) do not control the tax treatment for ceding commissions in indemnity reinsurance transactions, we must consider the NAIC's rules. Both parties agree that Merit's current deduction of ceding commissions followed the accounting rules for life insurance companies established by the NAIC.

Allowing insurance companies to immediately deduct ceding commissions for indemnity reinsurance but not for assumption reinsurance reflects the inherent differences between the two transactions and the complexities of the insurance industry.

> We realize that it may seem strange at first for the assumption reinsurance transaction and the indemnity reinsurance transactions at issue herein to have such different tax consequences when they are, at heart, so similar. An understanding of that difference must flow from the understanding of the complex and somewhat unique rules applicable to the insurance industry. . . .
>
> • • • • •
>
> . . . [R]eserves are deduction when set up and when added to; premiums are income as received; . . . and,

[12] 26 U.S.C. § 818(a) provides the following:

> (a) Method of Accounting.—All computations entering into the determination of the taxes imposed by this part shall be made—
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

> decreases in reserves give rise to income. Additionally, an insurance company may deduct currently expenses such as commissions, taxes, and underwriting expenses. It is within that framework that indemnity reinsurance, as the reinsurer's sale of insurance, falls. In essence, the allowance paid the ceding company is analogous to currently deductible underwriting expenses.

Beneficial Life, 79 T.C. at 646-47 (citation and footnote omitted).

If American General had withheld or deducted the ceding commissions from the reinsurance premiums prior to paying them to Merit, without specifically referring to "ceding commissions" in the agreements, the tax consequences would have been exactly the same as the Tax Court has held: Merit's taxable income would have been reduced by the ceding commissions in the year in which the reinsurance was issued. Merit's gross income would automatically have been reduced. Gross income reflects actual consideration received and this would have been reduced by the withheld amounts, thus producing the same net loss. Merit would not have had to subtract ceding commissions from the reinsurance premiums it received. In fact, it appears that two of the five agreements were structured in this manner. *See* note 2 *supra*.

Alternatively, Merit claims that ceding commissions are deductible under sections 162 and 809(d)(12) as one of many "other deductions" or ordinary business expenses. The Tax Court in *Beneficial Life* noted that ceding commissions in indemnity reinsurance transactions are analogous to currently deductible underwriting expenses of a direct insurer. 79 T.C. at 647. Those deductions are made pursuant to section 809(d)(12).[13] Because we hold

[13] Section 809(d)(12) provides the following in relevant part:

> (d) *Deductions.*—For purposes of subsections (b)(1) and (2), there shall be allowed the following deductions:

(Footnote continued on following page)

that ceding commissions are deductible from gross premiums under section 809(c)(1), we need not address Merit's alternative argument, although we agree with the Tax Court's analogy.

Conclusion

In sum, we conclude that the Code, treasury regulations and legislative history support the petitioner's position and the Tax Court's holding that ceding commissions paid by a reinsuring company or retained by the reinsured company, in an indemnity reinsurance transaction or in a modified indemnity reinsurance transaction in which both insurance companies have consented to treat the transaction as a conventional indemnity reinsurance transaction pursuant to 26 U.S.C. § 820(a), are immediately deductible by the reinsurer in the year in which the reinsurance is issued.

The opinion of the Tax Court is

AFFIRMED.

A true Copy:
Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

[13] *continued*

> (12) *Other Deductions.*—. . . , all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

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No. 88-396

Supreme Court, U.S.
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CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether "ceding commissions" payable by a reinsurer to the initial insurer as consideration for the right to share in the future income stream from a block of life insurance policies reinsured under contracts of indemnity reinsurance are fully deductible in the year paid, or, instead, whether such payments must be capitalized and amortized over the estimated life of the reinsurance agreements.

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v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a) is reported at 843 F.2d 201. The opinion of the Tax Court (Pet. App. 11a-22a) is unofficially reported at 51 T.C.M. (CCH) 1123.

JURISDICTION

The judgment of the court of appeals was entered on April 26, 1988. A petition for rehearing was denied on May 25, 1988 (Pet. App. 23a). The petition for a writ of certiorari was filed on August 22, 1988. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a Louisiana corporation engaged in the business of writing and reinsuring life, accident, and health

insurance contracts. During the years at issue, it qualified for federal income taxation as a "life insurance company" under Section 801 of the Internal Revenue Code.[1] In 1975 and 1976, petitioner entered into four indemnity reinsurance agreements with respect to a block of life insurance policies written by Transport Life Insurance Company. In these agreements, petitioner agreed to reinsure the aggregate total of 76.6% of Transport's liabilities under that block of policies by indemnifying Transport for that portion of its losses.[2] Some of the reinsurance was accomplished by means of conventional coinsurance agreements and the bulk of the reinsurance was accomplished by means of modified coinsurance agreements.[3] In addition, petitioner became entitled to 76.6% of the future premiums (less expenses) received on the policies. Pet. App. 2a, 4a-5a.

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[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect in 1975 and 1976, the years at issue (the Code).

[2] In indemnity reinsurance of the types involved here, the initial insurer and the reinsurer agree to share the premiums, expenses, and liabilities on a block of existing policies. The reinsurer in "indemnity reinsurance" does not become directly liable to policyholders, but agrees only to indemnify the initial insurer for its losses; the initial insurer continues to receive premiums and to pay expenses and benefits to the policyholders. This method of reinsurance contrasts with "assumption reinsurance," in which the reinsurer, in effect, steps into the shoes of the issuing company with respect to the policies, becoming directly liable to the policyholders and directly entitled to premium payments made by them. See generally Pet. App. 2a-4a; *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110, 110 n.2 (8th Cir. 1987).

[3] Under the "conventional coinsurance" agreements that covered 6.6% of the liabilities, petitioner established its own reserves to cover the reinsured liability and Transport reduced its reserves accordingly. Under the "modified coinsurance" agreements, covering 70% of the liabilities, Transport maintained the required reserves and was required to collect and pay over to petitioner the investment income derived from the assets supporting the reserves.

The agreements provided that Transport was to pay petitioner, as reinsurance premiums, amounts equal to the reserves required to be established by petitioner to cover the conventional coinsurance liability for this block of policies.[4] These reinsurance premiums were $675,762 for 1975, and $851,398 for 1976. The agreements further provided that petitioner was to pay "ceding commissions" to Transport, in consideration for the business acquired, of $680,000 for 1975 and $852,000 for 1976. These offsetting obligations were netted against each other prior to payment, with the result that petitioner paid Transport $4,238 in 1975 and $602 in 1976. In addition, petitioner paid Transport a finder's fee of $13,600 in 1975. Pet. App. 4a-5a.

Petitioner sought to deduct the full amount of the "ceding commissions," as well as the finder's fee, in the years of payment. Thus, petitioner reported tax losses of $693,600 for 1975 and $852,000 for 1976 as a result of the reinsurance transactions, although those transactions presumably had been entered into by petitioner with the

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[4] The reinsurance premiums provided for in the agreements covered only the conventional coinsurance agreements; Transport retained all assets corresponding to the reserve liabilities reinsured under the modified coinsurance agreements, which covered 70% of Transport's rights and liabilities on those policies. The parties, however, elected to have these transactions treated for tax purposes as if they were conventional coinsurance agreements (see Section 820 of the Code), and therefore petitioner was treated for tax purposes as having received reinsurance premiums under those agreements also, in the amount of the reserve liabilities attributable to the reinsured risks. See Pet. App. 6a.

expectation that they would be profitable.[5] The Commissioner disallowed the deductions claimed for the ceding commissions and finder's fee. The Commissioner determined that these amounts represented the acquisition costs for economic benefits having a useful life beyond the year of payment – namely, the right to petitioner's share of the future income stream paid on the reinsured policies. Accordingly, the Commissioner reasoned that the ceding commissions should be capitalized and amortized over the period of indemnification (which was stipulated to be seven years (Pet. App. 9a n.6)). *Id.* at 2a, 6a.

2. Petitioner filed a petition in the Tax Court seeking redetermination of the resulting deficiencies, and the Tax Court ruled in its favor (Pet. App. 11a-22a). Relying on its prior decision in *Beneficial Life Ins. Co.* v. *Commissioner*, 79 T.C. 627 (1982), the court held that ceding commissions paid to the initial insurer in an indemnity reinsurance transaction may be deducted in full in the year of payment (Pet. App. 16a-22a). The court explained that an indemnity reinsurance transaction is not treated as a sale of assets, but rather as the initial insurer's purchase of insurance from the reinsuring company. Under that view, the court reasoned, the ceding commissions were deductible from petitioner's income as "return premiums [or] * * * other consideration arising out of reinsurance ceded" under Section 809(c)(1) of the Code. Pet. App. 17a-18a. The Tax Court acknowledged that ceding commissions paid in connection with an assumption reinsurance transaction would have to be capitalized and amortized over the estimated

[5] The other aspects of the reinsurance transactions generated no taxable gain or loss to petitioner. The reinsurance premiums received by petitioner from Transport were reported as income, but those amounts were exactly offset by deductions allowed for the concomitant increase in petitioner's reserve liabilities for the reinsured policies. Pet. App. 6a.

life of the policies involved, but it justified this disparity as being required by the Code itself on the ground that the Code "treats an assumption reinsurance transaction as a sale by the initial insurer to the reinsuring company" (*id.* at 17a).

3. The court of appeals reversed (Pet. App. 1a-9a). Agreeing with the Eighth Circuit's decisions in *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110 (1987), and *Prairie States Life Ins. Co.* v. *United States*, 828 F.2d 1222 (1987), the court held that the ceding commissions reflected the acquisition costs of the intangible rights acquired by petitioner under the indemnity reinsurance agreements, and therefore were not fully deductible in the year of payment. The court recited the "fundamental rule that an amount expended to acquire an asset or economic interest, benefit or advantage with an income producing life extending substantially beyond the current taxable year may not be [expensed] in the year of payment but must be depreciated or amortized over its useful life" (Pet. App. 7a-8a), and it held that application of that rule here required that the ceding commissions be amortized over the estimated life of the reinsurance agreements. Quoting from its earlier decision in *Southwestern Life Ins. Co.* v. *United States*, 560 F.2d 627, 640-641 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978), the court of appeals specifically rejected the Tax Court's view that indemnity reinsurance should be accorded treatment different from assumption reinsurance on the ground that the latter is somewhat more analogous to the issuance of new insurance (Pet. App. 9a). Rather, the court concluded that the Code treats assumption reinsurance agreements the same as indemnity reinsurance agreements with respect to the deductibility of ceding commissions (*ibid.*).[6]

[6] The court of appeals also held that the $13,600 finder's fee must be amortized over the life of the policies (Pet. App. 9a). The Tax

DISCUSSION

1. The court of appeals correctly held that ceding commissions paid pursuant to indemnity reinsurance agreements represent the acquisition costs of intangible assets—namely, the reinsurer's share of the future income stream generated by the reinsured policies—and therefore must be capitalized and amortized over the indemnification period. Section 809(c)(1) of the Code, in allowing the deduction of "return premiums * * * and other consideration arising out of reinsurance ceded," was designed to ascertain true premium income by allowing appropriate adjustments for premium receipts that ultimately are not retained by the company receiving them. Thus, it would permit the initial insurer to deduct from its gross income premiums paid to a reinsurer to obtain indemnity reinsurance.

But no such adjustment is appropriate here. Contrary to petitioner and the Tax Court, Section 809(c)(1) should not be read to permit the immediate deduction of payments like ceding commissions paid by a reinsurer, which are inherently capital in nature. Permitting such a deduction would result in a gross distortion of income by mismatching the future income to be derived by a reinsurer from the reinsured policies with the current costs incurred to acquire the rights to that income. There is no reason to believe that Congress intended to permit insurance companies to distort their income in this way, which would constitute a drastic departure from the basic tax principles applicable to all other taxpayers who make current expenditures for future benefits. Nor is there reason to believe that Congress

Court had upheld the immediate deduction of the finder's fee, mistakenly stating that the Commissioner had conceded that the finder's fee should be currently deductible if the ceding commissions were held to be currently deductible (*id.* at 22a).

intended to establish such radically different tax consequences for indemnity reinsurers from those of assumption reinsurers, who are similarly situated for tax purposes in that each pays ceding commissions to obtain essentially the same rights to participate in the anticipated future income stream from the reinsured policies. Thus, we believe that the court of appeals correctly rejected petitioner's contentions. Because there exists a conflict in the circuits on this issue and because of its importance to the uniform taxation of a major industry, however, we do not oppose the petition for certiorari.[7]

2. Petitioner correctly states that the decision below and the Eighth Circuit's decisions in *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110 (1987), and *Prairie States Life Ins. Co.* v. *United States*, 828 F.2d 1222 (1987), directly conflict with the Seventh Circuit's recent decision in *Merit Life Ins. Co.* v. *Commissioner*, 853 F.2d 1435 (1988). In *Merit Life*, the court of appeals agreed

[7] The provisions of the Code pertaining to the taxation of life insurance companies were substantially revised by Section 211 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 720. The question presented here, however, was not addressed by Congress and does not appear to have been affected by the revision. Section 809(c)(1) is carried forward in the revised provisions in substantially the same form in Section 803(a)(1) and (b) of the amended Code, which applies to tax years beginning after December 31, 1983. The revision did change the language of the provision somewhat, replacing the phrase "reinsurance ceded" with the phrase "indemnity reinsurance." But there is no indication that this substitution was intended to effect any substantive change, and the revision does not answer the question presented here—whether an immediate deduction is permitted for ceding commissions paid by a reinsurer in connection with indemnity reinsurance. Thus, the question presented here, although litigated in the context of a statutory provision that has been revised, Section 809(c)(1), has continuing significance for future years under the current version of the Code.

with the Tax Court that the Code provides for radically different tax treatment of indemnity reinsurance transactions from that of assumption reinsurance transactions. The court found that, in the case of assumption reinsurance, the ceding commissions paid by the reinsuring company could be analogized to commissions paid to agents upon the issuance of a new insurance policy, and it concluded that Congress intended in Section 809(c)(1) to permit the current deduction of such ceding commissions. 853 F.2d at 1438-1439, 1442. The Seventh Circuit expressly noted that its decision could not be squared with the decision below and with the relevant Eighth Circuit decisions, which it characterized as "misunderstanding and misinterpret[ing] the Code" (*id.* at 1441).

We agree with petitioner that it is appropriate for this Court to grant certiorari here to resolve this conflict in the circuits. If the conflict is allowed to persist, insurance companies entering into indemnity reinsurance agreements will receive disparate tax treatment depending upon the circuit in which their case is litigated. The insurance industry reports that indemnity reinsurance agreements constitute a major portion of its business. It is estimated that $440 billion of life insurance was reinsured in 1987 alone, with a total of $1.78 trillion of reinsured life insurance outstanding at the end of that year. Because the general practice in the industry would suggest that most of that reinsurance is indemnity reinsurance, it is apparent that the tax treatment of ceding commissions paid in connection with indemnity reinsurance transactions is an issue of considerable monetary significance. See generally Brief for the American Council of Life Insurance and the National Association of Life Companies as Amici Curiae at 7. Moreover, the number of these transactions and the

volume of recent litigation on this issue[8] suggest that the lower courts will continue to struggle with the correct tax treatment of indemnity reinsurance transactions unless the conflict is resolved. Accordingly, the interest of achieving uniform treatment of similarly situated taxpayers and considerations of administrative convenience and judicial economy suggest that this Court should grant certiorari to resolve the conflict in the circuits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 1988

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[8] In addition to the cases cited, the question presented here is currently pending on appeal in *Oxford Life Ins. Co.* v. *United States*, No. 88-2295 (9th Cir.), a case that had previously been the subject of an appellate decision on a related issue involving the treatment of assumption reinsurance (see *Oxford Life Ins. Co.* v. *United States*, 790 F.2d 1370 (9th Cir. 1986)).

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IN THE

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OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

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BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

This brief is submitted with the written consent of counsel to both parties filed with the Clerk of the Court.

INTEREST OF THE AMICI CURIAE

The American Council of Life Insurance ("ACLI") is a trade association with 646 life insurance company members. These member companies account for 93 percent of all the life insurance business in force in the United States in legal reserve life insurance companies and hold 93 percent of the total assets of all United States life insurance companies. The National Association of Life Companies ("NALC") is a trade association with over

600 small and medium-sized life insurance company members, many of which are also members of the ACLI.

The issue considered by the United States Court of Appeals for the Fifth Circuit in this case involves the Federal income tax treatment of indemnity reinsurance transactions. Specifically, the issue is whether a life insurance company is entitled to deduct currently, in computing its taxable income, the ceding commissions it incurs in issuing indemnity reinsurance to another life insurance company.

As is explained in the argument, *infra*, member companies of the ACLI and the NALC frequently engage in indemnity reinsurance transactions, both as reinsurers and as ceding companies. The treatment of ceding commissions affects not only the tax liability of the companies issuing indemnity reinsurance, but also the cost to companies obtaining the indemnity reinsurance coverage. Thus, the issue in this case is of major importance to the members of the ACLI and the NALC.

SUMMARY OF ARGUMENT

For many years, life insurance companies have currently deducted the ceding commissions they incur in issuing indemnity reinsurance contracts. The Commissioner of Internal Revenue now contends that such ceding commissions are not currently deductible. The lower courts disagree on the issue.

Indemnity reinsurance is of major importance to the life insurance industry because life insurance companies regularly use indemnity reinsurance to ensure adequate distribution of risk, as well as to reduce surplus strain caused by issuing new coverage. The importance of indemnity reinsurance is demonstrated by the large amounts issued. The uncertainty as to the Federal income tax treatment of indemnity reinsurance ceding commissions should be resolved.

ARGUMENT

I. The Commissioner's Position that Reinsurers Cannot Deduct Indemnity Reinsurance Ceding Commissions and the Conflicting Decisions of the Lower Courts Have Created Uncertainty About the Federal Income Tax Treatment of Indemnity Reinsurance

In the 30 years since Congress enacted the Life Insurance Company Income Tax of 1959, Pub. L. No. 86-59, 73 Stat. 112 [hereinafter the 1959 Act], life insurance companies consistently have deducted the ceding commissions they incur in issuing indemnity reinsurance contracts. This treatment, which is identical to the treatment that has been required since 1951 by the National Association of Insurance Commissioners for state accounting purposes, was not publicly challenged by the Commissioner of Internal Revenue until 1982. *See* Rev. Rul. 82-69, 1982-1 C.B. 102. In that ruling, the Commissioner for the first time publicly contended that indemnity reinsurers must capitalize, rather than deduct, ceding commissions paid in an indemnity reinsurance transaction. *Id.*[1]

The United States Tax Court has consistently rejected the Commissioner's position and has held that ceding commissions paid in an indemnity reinsurance transaction are currently deductible. *See Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627 (1982); *Merit Life Ins. Co. v. Commissioner*, T.C. Memo 1986-480 [1986 P-H Memo T.C. 86-2188], *aff'd*, 853 F.2d 1435 (7th Cir. 1988); *Colonial Am. Life Ins. Co. v. Commissioner*, T.C. Memo 1986-226 [1986 P-H Memo T.C. 86-938], *rev'd*, 843 F.2d 201 (5th Cir. 1988); *Individual Life Assurance Co. v.*

[1] Prior to Rev. Rul. 82-69, the Commissioner had issued technical advice memoranda contending that indemnity reinsurance ceding commissions had to be capitalized. *See* PLR 7844002 (July 13, 1978); PLR 8205015 (Oct. 29, 1981). These technical advice memoranda do not constitute precedent and may not be used as such. *See* I.R.C. § 6110(j)(3).

Commissioner, T.C. Memo 1986-201 [1986 P-H Memo T.C. 86-339], *revised per non precedential memorandum sur order* (Oct. 8, 1987). The United States Court of Appeals for the Seventh Circuit has also rejected the Commissioner's position. *Merit Life Ins. Co. v. Commissioner*, 853 F.2d 1435 (7th Cir. 1988).

On the other hand, the United States Court of Appeals for the Eighth Circuit has agreed with the Commissioner that indemnity reinsurance ceding commissions should be capitalized, *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987), as has the United States Court of Appeals for the Fifth Circuit in the instant case. *Colonial Am. Life, supra. See also Modern Am. Life Ins. Co. v. Commissioner*, 818 F.2d 1386 (8th Cir. 1987), *rev'g Modern Security Life Ins. Co. v. Commissioner*, T.C. Memo 1985-629 [1985 P-H Memo T.C. 85-2799].[2]

The Commissioner's position, and the decisions of the Fifth and Eighth Circuits, have called into question the tax treatment of a fundamental part of an indemnity reinsurance transaction. Although each of the cases cited involves the treatment of indemnity reinsurance ceding commissions under the 1959 Act, the holdings of the decided cases are equally applicable under current law.[3] This uncertainty directly affects reinsurers which have for thirty years deducted ceding commissions paid to ced-

[2] The issue is also pending in the United States Court of Appeals for the Ninth Circuit on appeal from a United States District Court decision for the Commissioner. *Oxford Life Ins. Co. v. United States*, No. 88-2955 (9th Cir.), *on appeal from* No. CIV-84-959-PHX-RGS, slip op. (D. Ariz. Oct. 15, 1987).

[3] In the Deficit Reduction Act of 1984, Congress repealed the 1959 Act and enacted a new regime for taxing life insurance companies. P.L. 98-369, 98 Stat. 484, §§ 201-219 [hereinafter the 1984 Act]. However, the 1984 Act did not substantively alter the Internal Revenue Code provisions applicable to the treatment of indemnity reinsurance ceding commissions. *Compare* §§ 809(c)(1) and 809(d)(12) as in effect (during 1975 and 1976) under the 1959 Act *with* §§ 803(a)(1) and 805(b)(8) as in effect under the 1984 Act.

ing companies. In addition, the uncertainty indirectly affects all insurance companies which purchase indemnity reinsurance coverage because the price of such coverage naturally will reflect the tax treatment of ceding commissions paid by those companies which issue it.

II. The Federal Income Tax Treatment of Indemnity Reinsurance is of Major Importance to the Life Insurance Industry

There are two general types of reinsurance: indemnity reinsurance and assumption reinsurance. *See generally*, Steffen, Reinsurance, in LIFE and HEALTH INSURANCE HANDBOOK (D. Gregg and V. Lucas eds. 1973). Assumption reinsurance occurs relatively infrequently and typically is used to dispose of all of a life insurance company's business or a particular line of its business. *Id.*, at 1003-1004.

In contrast, indemnity reinsurance occurs regularly in the life insurance industry. Indemnity reinsurance is an insurance agreement by means of which a life insurance company, often termed a "ceding company," transfers all or a portion of its risk under a life insurance policy to another company, often termed a "reinsurer." *Id.*, at 991. The nature of indemnity reinsurance was summarized by the United States Court of Appeals for the Seventh Circuit in *Merit Life, supra*:

> In indemnity reinsurance, the ceding company does not relinquish any of its contractual interest in the policies it issued and remains directly liable to the policyholders. No relationship, contractual or otherwise, exists between the reinsurer and the policyholders. The ceding company pays the reinsurer a percentage of the premiums it received, upon issuance of the policies, proportional to the risk assumed by the reinsurer, which may be part or all of the total risk. The ceding company continues to pay claims and expenses and collect premiums, and pays the reinsurer a percentage of the future premiums again based on the risk transferred. In exchange,

> the reinsuring company reimburses (indemnifies) the ceding company for its share of the claims and expenses attributable to the risk reinsured and pays (or the ceding company retains) a ceding commission.

853 F.2d at 1436.

Indemnity reinsurance serves a wide variety of purposes, one of the most important of which is the spreading of risk.[4] The spreading of risk, known as risk distribution, is an essential element of insurance because it avoids the concentration of too much risk in one insurance company. *See* K. Black & H. Skipper, Jr., *supra* note 4, at 431; *see also Helvering v. LeGierse*, 312 U.S. 531 (1941).

The need to distribute risk, however, limits the amount of risk that an insurance company can safely assume by itself with respect to any one insured. *See generally* K. Black & H. Skipper, Jr., *supra* note 4, at 431. Every life insurance company thus establishes a limit on the maximum amount of life insurance protection that it will carry on any one individual. *See* Steffan, *supra*, at 992. These limits, known as "retention" limits, vary considerably in size, from $5,000 to over $1,000,000, but all companies have them.[5] A.M. Best Co., BEST'S AGGREGATES & AVERAGES LIFE-HEALTH (7th ed. 1988) 48 [hereinafter BEST'S AGGREGATES and AVERAGES].

While retention limits are necessary to avoid excessive concentration of risk, those limits standing alone might

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[4] Indemnity reinsurance is also used to reduce the drain on surplus caused by writing new business, thereby allowing small and growing life insurance companies to continue issuing insurance, and to stabilize the mortality experience of the ceding company. *See* K. Black & H. Skipper, Jr., LIFE INSURANCE 431 (11th ed. 1987).

[5] A number of considerations are involved in determining a life insurance company's retention limit, including the amount of the insurer's surplus, expected mortality, the nature of the policies and their distribution among age groups, and the cost of obtaining indemnity reinsurance. Steffan, *supra*, at 992-93.

prevent a life insurance company from issuing a life insurance policy for the amount of life insurance protection a prospective insured needs. It is indemnity reinsurance which makes it possible for a life insurance company to issue the desired amount of insurance while protecting itself against loss in excess of its retention limit. *See* Steffan, *supra*, at 991-92. For example, a small life insurance company which has determined that it cannot safely carry a risk of more than $10,000 per insured may receive an application from an individual who desires coverage of $25,000. Through indemnity reinsurance, the company can nevertheless issue the $25,000 policy, retaining $10,000 of risk and ceding the remaining risk to an indemnity reinsurer. Indemnity reinsurance thus allows insurance companies to achieve the degree of risk spreading necessary to make insurance work.

The importance of reinsurance to the life insurance industry is evidenced by its volume. At the end of 1987, the life insurance industry had $8.87 trillion of life insurance in force. BEST'S AGGREGATES and AVERAGES, at 50. Of that amount, $1.78 trillion was reinsured. *Id.* at 49. Furthermore, in 1987, the life insurance industry issued $1.52 trillion of new life insurance coverage, and $.44 trillion of coverage was reinsured. *Id.*, at 49-50. A precise indentification of the proportion of this reinsurance which is indemnity reinurance is not possible, but given the frequency and purposes of indemnity reinsurance it is believed that the preponderance of this reinsurance is indemnity reinsurance.

In summary, indemnity reinsurance is necessary to the daily operations of the life insurance business, enabling life insurance companies to effect adequate distribution of risk and to reduce surplus strain. In addition, indemnity reinsurance is issued in substantial amounts. Thus, the Federal income tax treatment of indemnity reinsurance is of major importance to the life insurance industry, and the uncertainty created by the Commis-

sioner's position and the conflicting judicial decisions should be resolved.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

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QUESTION PRESENTED

Whether Colonial American Life Insurance Company, in calculating gain (or loss) from operations under section 809(b) of the Internal Revenue Code, may deduct in the year incurred the ceding commissions it incurred in issuing indemnity reinsurance?

PARTIES TO THE PROCEEDING

Pursuant to Supreme Court Rule 28.1, Colonial American Life Insurance Company has filed with the Court a statement listing all of its parent companies, subsidiaries (except wholly-owned subsidiaries), and affiliates.

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OPINIONS BELOW

The opinion of the court of appeals (Petitioner's Appendix ("Pet. App.") 1a-9a) is reported at 843 F.2d 201. The opinion of the Tax Court (Pet. App. 11a-22a) is unofficially reported at 51 T.C.M. (CCH) 1123.

JURISDICTION

The judgment of the court of appeals (Pet. App. 9a) was entered on April 26, 1988. A timely filed petition for rehearing was denied on May 25, 1988. (Pet. App. 23a) The petition for a writ of certiorari was filed on August 22, 1988, and was granted on December 5, 1988. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of sections 809, 818, and 162 of the Internal Revenue Code of 1954 (26 U.S.C.),[1] and of section 1.809-4 of the Treasury Regulations on Income Tax (26 C.F.R.), are set out at Pet. App. 25a-38a.

STATEMENT OF THE CASE

A. *The Facts*

During the years in issue, 1975 and 1976, Colonial American Life Insurance Company ("Colonial") was a life insurance company, as defined in section 801(a), engaged in the business of issuing life and accident and health insurance contracts. (Pet. App. 12a) During these years, among the life insurance contracts Colonial issued were four indemnity reinsurance contracts issued to Transport Life Insurance Company ("Transport"). (Pet. App. 14a-15a) It is this insurance which is involved in this case.

Indemnity reinsurance is insurance issued by one insurance company (the reinsurer) to another insurance company (the ceding company) under which the reinsurer indemnifies the ceding company against all or a part of the risks arising out of the insurance policies issued by that ceding company. (Pet. App. 13a, 17a) Under indemnity reinsurance, the ceding company (also sometimes referred to as the "primary" or "direct" insurer) does not relinquish any of its interests in the policies that it issues to the public (so-called "directly-written policies" or "directly-written insurance"). It remains directly liable to its policyholders, who generally have no knowledge of the indemnity reinsurance. (Pet. App. 13a)

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1954 (the "Code"), 26 U.S.C., as in effect during the years in issue. Other sections of the Code and the Treasury Regulations discussed herein are set out at Pet. App. 25a-38a.

Under indemnity reinsurance, there is no relationship whatsoever between the reinsurer and the policyholders of the ceding company. The ceding company, as the insurer under the directly-written policies, continues to collect premiums and to pay claims and expenses under such policies. Under indemnity reinsurance, the reinsurer reimburses the ceding company for the claims and expenses such ceding company incurs that are attributable to the risks reinsured. (Pet. App. 13a)

If any of the directly-written policies were to terminate for any reason, the insurance provided by the reinsurer to the ceding company in respect of such policies also would terminate. An indemnity reinsurance contract typically can be terminated by mutual consent of the ceding company and the reinsurer. An indemnity reinsurance contract usually contains a "recapture" provision, under which the ceding company can eliminate the insurance coverage under the indemnity reinsurance with respect to certain risks by "recapturing" such risks. (Tax Court Transcript ("Tr.") 39-40)

Indemnity reinsurance is fundamentally different from assumption reinsurance. (Pet. App. 12a-13a) An assumption reinsurance agreement is the means by which one insurance company purchases or acquires insurance policies from another insurance company. Once the purchase of insurance policies has been effected through an assumption reinsurance agreement, the purchasing company substitutes itself for the selling company and becomes the direct insurer under the policies it acquired. (Stipulation of Facts ("Stip.") ¶ 11a) The purchaser, therefore, assumes all of the liabilities under the policies acquired and becomes directly liable to pay all claims thereunder and all expenses with respect to such policies. (Pet. App. 12a)

Owners of policies which have been purchased by an insurance company pursuant to an assumption reinsurance agreement are issued assumption certificates informing them of the assumption transaction and directing

them to remit any future premium payments to the purchasing company. (Tr. 28) Since an assumption reinsurance transaction is the purchase by one insurance company of the insurance policies of another insurer and does not involve a continuing relationship (insurance or otherwise) between such companies, an assumption reinsurance agreement would never contain a provision allowing the selling company to "recapture" at some future date the insurance policies it sold pursuant to that agreement. (Tr. 40-41)

Under the four indemnity reinsurance contracts involved in this case, Colonial, as the reinsurer, agreed to reinsure certain risks arising out of life insurance policies originally issued by Transport, the ceding company.[2] (Pet. App. 14a-15a; Joint Exhibits ("Jt. Ex.") 4-D, 5-E, 9-I, 10-J) There is no dispute that these four contracts are indemnity reinsurance contracts, not assumption reinsurance agreements. (Tr. 53-57)

Colonial issued two of the indemnity reinsurance contracts in 1975 (Pet. App. 14a) and the other two in 1976. (Pet. App. 15a) Both of the indemnity reinsurance contracts issued in 1976 reinsured risks arising out of the same policies covered by the indemnity reinsurance contracts issued in 1975 and merely increased the percentage (to 6.6 percent under the coinsurance and to 70 percent under the modified coinsurance) of Transport's risks under those policies that Colonial agreed to reinsure. (Pet. App. 15a; Jt. Ex. 4-D, 5-E, 9-I, 10-J)

Each of the indemnity reinsurance contracts provided for Colonial to pay Transport a ceding commission which

[2] Two of the indemnity reinsurance contracts were coinsurance contracts and two were modified coinsurance contracts which the parties had elected, in accordance with section 820, to have treated like coinsurance contracts for tax purposes. Coinsurance and modified coinsurance reinsurance are two of the three principal types of indemnity reinsurance. *United States v. Consumer Life Insurance Co.*, 430 U.S. 725, 746-47 (1977). (Risk premium reinsurance, also known as yearly renewable term reinsurance, is the third principal form of such reinsurance. (Tr. 34))

was negotiated, as is typically done by the parties to an indemnity reinsurance contract. (Pet. App. 15a) In negotiating the pricing of those contracts, essentially the same elements were taken into account as are taken into account in pricing directly-written insurance, *e.g.*, mortality, lapse, and expense (agents' commissions and overhead) assumptions, as well as a projection of future profits anticipated to be realized from the insurance issued. (Tr. 36-39, 50-51; Stip. ¶ 28)

Colonial, as required, filed Annual Statements for 1975 and 1976 with the insurance department of each state in which it was engaged in the life insurance business. (Stip. ¶¶ 16, 23) The form for the Annual Statement and the accounting treatment required to be used therein (sometimes referred to as "NAIC accounting" or "NAIC Annual Statement accounting") are prescribed by the National Association of Insurance Commissioners ("NAIC"). (Stip. ¶ 2)

NAIC accounting treatment for indemnity reinsurance is the same as NAIC accounting treatment for directly-written insurance. (Tr. 47-48) In each case, in calculating its net gain from operations ("Summary of Operations," page 4 of the NAIC Annual Statement), the company issuing the insurance is required to (1) include in premiums (page 4, line 1) the amount of premiums received from its insured, whether the insured is an individual policyholder or an insurance company like Transport, (2) include as part of its deduction for the increase in reserves (page 4, line 17) the reserves required to be established with respect to its liabilities under such insurance, and (3) include as part of its deduction for commissions incurred in issuing insurance (page 4, line 21) the commissions and other expenses incurred in issuing such insurance. (Tr. 33, 41, 48) NAIC accounting precludes a life insurance company from treating commissions and other expenses incurred in issuing indemnity reinsurance or directly-written insurance as cre-

ating or relating to an asset. (Tr. 47) Colonial followed NAIC accounting in its 1975 and 1976 NAIC Annual Statements in reporting the indemnity reinsurance contracts involved here. (Stip. ¶¶ 16, 23; Tr. 43-46)

B. *The Proceedings Below*

For each of the years in issue, in calculating gain (or loss) from operations on its federal income tax returns, Colonial, consistent with NAIC Annual Statement accounting, deducted in the year incurred the ceding commissions it paid to Transport under the indemnity reinsurance contracts in issue. (Stip. ¶ 1)

On audit, the Commissioner of Internal Revenue (the "Commissioner") disallowed Colonial's deductions of those ceding commissions[3] on the theory that such amounts were attributable to the acquisition of an intangible asset with an indeterminate useful life. Alternatively, the Commissioner determined that such amounts were attributable to the cost of acquiring an asset with a determinable useful life and that they must be amortized over the estimated life of that asset.[4] (Pet. App. 15a-16a) Colonial petitioned the Tax Court for a redetermination of the deficiencies determined by the Commissioner.

The Tax Court found that the Code treats indemnity reinsurance as the issuance of insurance by the reinsurer to the primary insurer and held that ceding commissions

[3] Colonial also paid a "finder's fee" in 1975 to a third party in connection with the indemnity reinsurance contracts in issue. That fee was deducted on its 1975 tax return and was disallowed by the Commissioner. (Pet. App. 15a-16a)

[4] The parties stipulated for purposes of this case that if the Tax Court agreed with the Commissioner's determination that the commissions were not deductible in full in the years incurred, the indemnity reinsurance contracts would each be treated as having an estimated useful life of seven years and the ceding commissions could be amortized over that period on a straight-line basis. (Tr. 19)

incurred in issuing indemnity insurance are currently deductible. (Pet. App. 17a-18a)

The Court of Appeals for the Fifth Circuit reversed the Tax Court and held that the ceding commissions incurred by Colonial in issuing the indemnity reinsurance in question are not currently deductible.[5] (Pet. App. 9a)

SUMMARY OF ARGUMENT

This case concerns the federal income tax treatment of ceding commissions incurred by a life insurance company in issuing indemnity reinsurance. That treatment is governed by the rules which Congress prescribed for taxing life insurance companies in Part I of Subchapter L of the Code.[6] These rules treat indemnity reinsurance, consistent with its nature, as the issuance of insurance, *not* as the acquisition of an asset. Thus, the taxing pattern prescribed by Congress in Part I of Subchapter L for taxing life insurance companies with respect to the insurance they issue applies not only to directly-written insurance but also to indemnity reinsurance. *Infra* pp. 10-14.

Under this pattern, premiums received, reserves required, and expenses incurred in connection with the issuance of insurance, whether directly-written insurance or indemnity reinsurance, are taken into account currently. One such expense is the ceding commission in-

[5] The court of appeals held that the same tax treatment applied to the finder's fee. It is Colonial's position that the principles governing the tax treatment of ceding commissions under indemnity reinsurance also control the tax treatment of that fee.

[6] Part I of Subchapter L (sections 801 through 820) was enacted into law by the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 ("1959 Act"). Although the provisions of Part I of Subchapter L enacted by the 1959 Act have been amended a number of times, none of the amendments have changed the provisions governing the tax treatment of ceding commissions under indemnity reinsurance.

curred in an indemnity reinsurance transaction. That expense, like the other expenses of issuing insurance, is currently deductible. This result is mandated by section 809(c)(1). The Tax Court, based on a careful analysis of that provision as well as the rest of Part I of Subchapter L, its legislative history, and the regulations, has so held in every case in which it has been presented with this issue (including the case involving Colonial), and the Seventh Circuit recently affirmed the Tax Court in *Merit Life Insurance Co. v. Commissioner*, 853 F.2d 1435 (7th Cir. 1988).[7] *Infra* pp. 21-24.

The premise for the Commissioner's position that ceding commissions incurred under indemnity reinsurance are not currently deductible is the unfounded contention that indemnity reinsurance is "essentially the same in substance" as assumption reinsurance. From that premise, the Commissioner reasons that indemnity reinsurance should not be treated for tax purposes as insurance but, like assumption reinsurance, should be treated as the acquisition of an asset.[8]

The Commissioner's position was accepted by the Fifth Circuit in this case. The Fifth Circuit, relying on the decisions of the Eighth Circuit in *Modern American Life Insurance Co. v. Commissioner*, 830 F.2d 110, *as amended* (8th Cir. 1987), and *Prairie States Life Insurance Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987), failed to recognize that indemnity reinsurance and assumption reinsurance are inherently different. These courts of appeals thus erred in not giving effect to the tax treatment mandated for ceding commissions incurred in indemnity reinsurance transactions by Part I

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[7] On December 8, 1988, the Solicitor General petitioned this Court for a writ of certiorari to the Seventh Circuit in *Merit Life*.

[8] *See, e.g.*, Brief for the Commissioner to the Fifth Circuit in this case, p. 47.

of Subchapter L, its legislative history, and the regulations. *Infra* pp. 14-26.

In contrast to indemnity reinsurance, an assumption reinsurance agreement effects the acquisition of insurance policies by one insurance company from another insurer and is so treated for federal income tax purposes. Thus, the federal income tax treatment of the commissions incurred in each type of transaction is different. In the case of indemnity reinsurance (as well as directly-written insurance), the commission is an expense incurred by an insurance company in issuing insurance and therefore is currently deductible. In the case of assumption reinsurance, the commission is the purchase price paid by an insurance company to acquire insurance policies and therefore must be amortized over the estimated life of those policies. *Infra* pp. 14-26.

The manner in which ceding commissions under indemnity reinsurance are required to be treated in determining gain (or loss) from operations under section 809(b) is consistent with the manner in which such commissions are required to be treated in determining net gain from operations under NAIC accounting. This is not surprising, since the rules Congress provided in Part I governing the taxation of life insurance companies were based on NAIC Annual Statement accounting practices. Pursuant to section 818(a), as interpreted by this Court, "except when the rules of accrual accounting dictate a contrary result, NAIC procedures 'shall' apply" for federal income tax purposes. *Commissioner v. Standard Life & Accident Insurance Co.*, 433 U.S. 148, 159 (1977). The rules of accrual accounting do not dictate a result contrary to NAIC accounting in the present case. *Infra* pp. 26-30.

ARGUMENT

COLONIAL IS ENTITLED TO DEDUCT CURRENTLY THE CEDING COMMISSIONS IT INCURRED IN ISSUING INDEMNITY REINSURANCE

A. Indemnity Reinsurance Is Insurance And Is Treated By The Code As Insurance

Indemnity reinsurance is insurance which is issued by one insurance company (the reinsurer) to another insurance company (the ceding company),[9] a fact that Congress was fully aware of when it wrote the 1959 Act. Consistently, Congress treated indemnity reinsurance[10] as insurance in Part I of Subchapter L, and *not* as the acquisition of an asset. Thus, in discussing indemnity reinsurance under the taxing pattern prescribed in the 1959 Act,[11] the Senate Finance Committee stated:

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[9] *See, e.g.*, W. W. Steffen, "Reinsurance," in *Life and Health Insurance Handbook*, at 991 (D.W. Gregg & V.B. Lucas, 3d ed. 1973) ("Reinsurance is an insurance agreement or contract under which one insurer, often called the *ceding company*, is indemnified against loss by another insurer, called the *reinsurer*, arising out of an insurance policy written by the original insurer. Thus, a reinsurance contract is a separate insurance agreement and presupposes the existence of an original policy.") (Emphasis included; footnote omitted.); H.T. Kramer, "The Nature of Reinsurance," in *Reinsurance*, at 4 (R. Strain 1980) ("Reinsurance is a form of insurance. As such, a contract of reinsurance is an insurance contract.").

[10] Indemnity reinsurance is sometimes referred to in the Code and the regulations as "reinsurance ceded." *E.g.*, section 809(c)(1); Treas. Reg. § 1.809-4(a)(1)(ii). The regulations make it clear that the term "reinsurance ceded" includes indemnity reinsurance, but not assumption reinsurance. *E.g.*, Treas. Reg. § 1.809-4(a)(1)(iii).

[11] Although the 1959 Act established a three-phase pattern for determining a life insurance company's taxable income, only phase two, the calculation of gain (or loss) from operations under section 809(b), is involved in this case. *See United States v. Atlas Life Insurance Co.*, 381 U.S. 233, 235 n.2 (1965), which describes more fully the pattern for the taxation of life insurance companies. "Gain from Operations" is defined in section 809(b)(1) as that

> Three forms of this indemnity reinsurance have been developed. The first of these, called coinsurance, calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly. Any expenses incurred by the primary insurer with respect to the policy are reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems.

S. Rep. No. 291, 86th Cong., 1st Sess. 38-39, *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1613-14.

The courts have recognized on numerous occasions that indemnity reinsurance is insurance and is so treated by the Code. *E.g.*, *Merit Life*, 853 F.2d at 1442 ("[b]ecause substantively indemnity reinsurance is the sale of insurance . . . it follows that, in addition to the explicit provisions of the Code and treasury regulations, the principles governing the sale of insurance . . . also apply to indemnity reinsurers"); *Cologne Life Reinsurance Co. v. Commissioner*, 80 T.C. 859, 862 (1983) ("[u]nder these sections [801-820], the issuance of indemnity life reinsurance is treated generally as the issuance of life insurance"), *aff'd by summary order*, 732 F.2d 141 (2d Cir. 1984) (unpublished opinion); *Beneficial Life Insurance Co. v. Commissioner*, 79 T.C. 627, 646 (1982) ("indemnity reinsurance . . . is treated as the ceding company's purchase of insurance"). *See also Oxford Life Insurance Co. v. United States*, 790 F.2d 1370, 1376 (9th Cir. 1986) ("an indemnity reinsurance transaction is the purchase of insurance protection [by] the reinsured").

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amount by which certain items of income described in section 809(b)(1), which include the gross amount of premiums under section 809(c)(1), exceed the deductions provided by section 809(d). "Loss from Operations" is defined in section 809(b)(2) as the amount by which the deductions provided by section 809(d) exceed the items of income described in section 809(b)(2), which are the same items of income described in section 809(b)(1).

The rules prescribed in Part I of Subchapter L for determining how life insurance companies are taxed with respect to the insurance they issue generally draw no distinctions between directly-written insurance and the form of insurance known as indemnity reinsurance. Thus, the provisions of Part I apply as written to indemnity reinsurance,[12] except where indemnity reinsurance has been specifically excluded from the application of certain Code sections.[13]

In fact, the Commissioner has taken issue with this point in one respect only. The Commissioner did not challenge any item of income under section 809(b)(1), or any item of deduction under section 809(d), which was taken into account by Colonial in respect of the indemnity reinsurance in question, except one—the expenses incurred in issuing such reinsurance. Therefore, what the Commissioner has asked the courts to do, and what the Fifth Circuit did, is to treat indemnity reinsurance like directly-written insurance in all respects ex-

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[12] *See, e.g.*, section 801(a) of the Code, defining the term "life insurance company" to mean an insurance company which is engaged in the business of issuing life insurance and annuity contracts (provided certain requirements are met); section 809(d)(1), providing a deduction for all claims and benefits accrued and all losses incurred during the year on insurance and annuity contracts. Although neither section refers specifically to indemnity reinsurance, it is undisputed that each covers such reinsurance.

[13] When it chose to do so, Congress expressly excluded indemnity reinsurance from the application of certain Code sections. *See, e.g.*, section 806(a) and section 809(d)(7). Moreover, when it chose to do so, Congress expressly provided special rules for the treatment of indemnity reinsurance. *See* section 820 which prescribed special rules for the type of indemnity reinsurance known as modified coinsurance because Congress was concerned that, absent those special rules, such reinsurance might have special tax problems under the rules Congress had otherwise prescribed in Part I of Subchapter L. S. Rep. No. 291, *supra*, at 39, 1959 U.S. Code Cong. & Admin. News at 1614; *see also Consumer Life*, 430 U.S. at 747-48.

cept one, namely, the expenses incurred by life insurance companies in issuing such reinsurance.[14]

The Commissioner's request to pick and choose among Code provisions and to treat indemnity reinsurance as insurance for some purposes, but not for purposes of determining the proper tax treatment of expenses incurred in issuing indemnity reinsurance, is totally unfounded. It has been repeatedly rejected by the Tax Court [15] whose special expertise in technical tax matters warrants deference.[16] It has also been rejected by the Seventh Circuit which affirmed the Tax Court in *Merit Life*. There is no basis in Part I of Subchapter L to treat an issuer of

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[14] It was not until over 20 years after the passage of the 1959 Act that the Commissioner first announced, in Rev. Rul. 82-69, 1982-1 C.B. 102, the official position of the Internal Revenue Service that ceding commissions under indemnity reinsurance are not currently deductible. Prior to that time, the Commissioner's published position on the tax treatment of such commissions was set forth in Rev. Rul. 70-552, 1970-2 C.B. 141. This ruling held that—

> the taxpayer is entitled to a deduction for commission expense equal to the amount of the ceding commission due the primary insurer as an ordinary and necessary business expense incurred . . . in the taxable year in which the reinsurance coverage becomes effective.

Although Rev. Rul. 70-552 involved an insurance company taxed under Part III of Subchapter L of the Code, its holding is equally applicable to insurance companies taxed under Part I.

[15] *Beneficial Life*, 79 T.C. at 647-48; *Merit Life Insurance Co. v. Commissioner*, 52 T.C.M. (CCH) 658, 660 (1986), *aff'd*, 853 F.2d 1435 (7th Cir. 1988); *Colonial American Life Insurance Co. v. Commissioner*, 51 T.C.M. (CCH) 1123, 1126 (1986), *rev'd*, 843 F.2d 201 (5th Cir. 1988); *Individual Life Assurance Co. v. Commissioner*, 51 T.C.M. (CCH) 1028, 1030 (1986) (revised per memorandum sur order (Oct. 8, 1977) because appeal would be to the Eighth Circuit); *Modern Security Life Insurance Co. v. Commissioner*, 51 T.C.M. (CCH) 188, 189-90 (1985), *rev'd sub nom. Modern American Life Insurance Co. v. Commissioner*, 830 F.2d 110, *as amended* (8th Cir. 1987).

[16] *Dobson v. Commissioner*, 320 U.S. 489, 502 (1943).

insurance to other insurance companies differently from an issuer of insurance to the public with respect to the expenses each incurs in issuing its insurance.[17]

B. Indemnity Reinsurance Is Inherently Different From Assumption Reinsurance And Is Treated By The Code Differently From Assumption Reinsurance

In adopting the position of the Commissioner in this case, the Fifth Circuit concluded that it found no "clear difference in the statute [Code] for treatment of assumption reinsurance contracts and indemnity reinsurance contracts" and that therefore a " 'general' tax rule" must be applied. *Colonial American Life Insurance Co. v. Commissioner*, 843 F.2d 201, 204 (5th Cir. 1988).[18] Under the "general" tax rule advanced by the Commissioner, expenses incurred to acquire an asset must be amortized over the expected life of the asset. The Fifth Circuit held that, under this "general" tax rule, the ceding commissions incurred by Colonial in issuing the indemnity reinsurance in question "must be depreciated or amortized over the useful life of the interest acquired." *Id.* at 205.

The premise for this holding is that the Code treats indemnity reinsurance as the acquisition of an asset, *not* as insurance. That premise is wrong: it reflects a misunderstanding of the nature of indemnity reinsurance as

[17] If the Commissioner's position were upheld, those insurers known as professional reinsurers, the principal or exclusive insurance business of which is the issuance of indemnity reinsurance, would be treated differently for purposes of Part I of Subchapter L from those companies issuing only directly-written insurance. This would clearly be contrary to congressional intent. *See* the Senate Finance Committee Report quoted *supra* p. 11.

[18] In holding for the Commissioner, the Fifth Circuit embraced the Eighth Circuit's reasoning in *Modern American* and *Prairie States*. As demonstrated below, the Eighth Circuit's reasoning, which the Fifth Circuit adopted, is flawed.

contrasted to assumption reinsurance, as well as a misunderstanding and misinterpretation of Part I of Subchapter L.[19]

The essence of indemnity reinsurance is that one insurance company (the reinsurer) agrees to reinsure the risks arising out of another company's (the ceding company's) insurance policies, thereby creating an insurance relationship between those insurance companies, but establishing no relationship (insurance or otherwise) between the reinsurer and the policyholders of the ceding company.

In contrast, the essence of an assumption reinsurance transaction is that it effects the purchase by one insurance company of the insurance policies of another insurance company, thereby substituting the purchasing company for the selling company as the direct insurer under the policies purchased, but creating no continuing relationship (insurance or otherwise) between the two insurance company parties to the transaction.[20]

Indemnity reinsurance therefore is fundamentally different from assumption reinsurance.[21] This was recognized not only by the Tax Court, but also by the Seventh Circuit in *Merit Life*. The court of appeals stated:

> From the reinsuring company's perspective, indemnity reinsurance is not an acquisition of an intang-

[19] *Merit Life*, 853 F.2d at 1440-42. *See* cases cited *supra* note 15; *see also Oxford Life*, 790 F.2d at 1376.

[20] Indeed, the use of the word "reinsurance," when referring to an assumption transaction, is somewhat misleading, since such a transaction is really the means by which one insurance company purchases insurance policies from another insurance company.

[21] The characteristics of indemnity reinsurance and of assumption reinsurance, which illustrate the fundamental differences between those two types of transactions, are described in detail in the Statement of the Case, *supra* pp. 2-4.

ible asset with a useful life of more than one year. By its nature, an indemnity reinsurance transaction is, from the perspective of the reinsurer, simply an indemnity or co-insurance arrangement, in substance, the sale of an insurance policy by the reinsurer to the ceding company. Economically, it is substantially the same as the sale of any other policy. In contrast, assumption reinsurance is by its nature the purchase of already issued insurance policies and the elimination of any participation or interest of the selling or ceding company.

853 F.2d at 1441. *See also* cases cited *supra* note 15.

In recognition of the basic differences between indemnity reinsurance and assumption reinsurance, Congress drew distinctions between them in Part I of Subchapter L of the Code. For example, sections 806(a) and 809(d)(7) specifically apply only to assumption reinsurance and specifically exclude indemnity reinsurance from their application.[22]

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[22] Section 806(a) provides:

> For purposes of this part, if, during the taxable year, there is a change in life insurance reserves attributable to the transfer between the taxpayer and another person of liabilities under contracts taken into account in computing such reserves, then, under regulations prescribed by the Secretary, the means of such reserves, and the mean of the assets, shall be appropriately adjusted, on a daily basis, to reflect the amounts involved in such transfer. *This subsection shall not apply to reinsurance ceded to the taxpayer or to another person.*

(Emphasis added.)

Section 809(d)(7) allows a company that sells its insurance policies to another insurance company in an assumption reinsurance transaction a deduction for—

> [t]he consideration (*other than consideration arising out of reinsurance ceded*) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(Emphasis added.)

The legislative history of the 1959 Act confirms congressional recognition of the fundamental differences between indemnity reinsurance and assumption reinsurance and congressional intent to treat indemnity reinsurance and assumption reinsurance differently for tax purposes. Thus, in discussing the nature of indemnity reinsurance and the fact that it presented "few special tax problems" under the 1959 Act, the Senate Finance Committee contrasted indemnity reinsurance with assumption reinsurance, stating:

> Modified coinsurance is a form of indemnity reinsurance (*as contrasted to assumption reinsurance*) to indemnify an insurer against a risk it has assumed. Hence, *as distinct from assumption reinsurance*, the initial risk in this case remains with the insurer but he covers this risk by reinsuring part or all of a contract with another insurance company (referred to here as the reinsurer).

S. Rep. No. 291, *supra*, at 38, 1959 U.S. Code Cong. & Admin. News at 1613. (Emphasis added.)

The legislative history of the Deficit Reduction Act of 1984 ("DEFRA") reaffirmed these principles in connection with the revisions made by Congress to Part I of Subchapter L:

> *The Code distinguishes between indemnity reinsurance (or reinsurance ceded) and assumption reinsurance.* The first is an arrangement whereby the ceding company remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. The second is an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the ceding company. *Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.*

Staff of the Joint Comm. on Taxation, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 633 (Comm. Print 1984) (hereinafter "General Explanation"). (Emphasis added.) *See also* LTR 8742004 (June 30, 1987), where the Commissioner stated this explanation almost verbatim in a Technical Advice Memorandum issued just prior to his appeal to the Seventh Circuit in the *Merit Life* case.

Consistent with the Code and its legislative history, the Treasury Department and the Internal Revenue Service have also differentiated between indemnity reinsurance and assumption reinsurance in the regulations issued after the 1959 Act became law. Thus, for example, in defining indemnity reinsurance ("reinsurance ceded"), the regulations make it clear that the term does *not* include assumption reinsurance.[23] Consistently, in defining assumption reinsurance, the regulations make it clear that the term does *not* include indemnity reinsurance.[24]

The Treasury Department and the Internal Revenue Service have promulgated regulations under specific Code

[23] Treas. Reg. § 1.809-4(a)(1)(iii) states—

> For purposes of section 809(c)(1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. *Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions.*

(Emphasis added.)

[24] Treas. Reg. § 1.809-5(a)(7)(ii) states—

> For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. *Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809-4).*

(Emphasis added.)

sections in Part I of Subchapter L, which apply *only* to assumption reinsurance transactions. One of these regulations is Treas. Reg. § 1.817-4(d).[26] That regulation, which, by its terms, applies *solely* to assumption reinsurance, *not* to indemnity reinsurance, prescribes the tax treatment of assumption reinsurance transactions.[26] Subsection (2)(ii) of Treas. Reg. § 1.817-4(d) specifically addresses ceding commissions and requires the amortization, rather than the current deduction, of such commissions *only* in the case of assumption reinsurance, *not* in the case of indemnity reinsurance.[27]

[25] *See also* Treas. Reg. §§ 1.806-3(a) and 1.809-5(a)(7), which implement sections 806(a) and 809(d)(7), and apply solely to assumption reinsurance, not to indemnity reinsurance. *See supra* note 22.

[26] Treas. Reg. § 1.817-4(d), which relates solely to assumption reinsurance transactions after 1958, was issued as a regulation under section 817 (captioned "Rules Relating to Certain Gains and Losses"), which generally involved gains and losses on the sale or exchange of property by a life insurance company. Section 817(e) (as enacted by the 1959 Act) provided that any assumption reinsurance transaction occurring *in 1958* was to be treated as a sale of a capital asset by the insurance company selling its insurance policies to another insurer. Since, under section 817(d) (as enacted by the 1959 Act), capital gains of life insurance companies from sales or exchanges of property occurring prior to 1959 were excluded from income, the gain to the selling company from an assumption reinsurance transaction occurring before 1959 was not subject to tax. Treas. Reg. § 1.817-4(d) was promulgated to clarify that gain to a selling company from an assumption reinsurance transaction occurring *after 1958* was not to be accorded favorable capital gain treatment, although such a transaction was still to be treated as a sale of insurance policies by one company to another insurer. There has never been any suggestion of which Colonial is aware that an indemnity reinsurance transaction, whether occurring before, during, or after 1958, is to be treated as a *sale of property by the ceding company.*

[27] Treas. Reg. § 1.817-4(d)(2)(ii) states—

> *In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809-5) transaction,* a reinsurer shall in any taxable year beginning after December 31, 1957:

Despite the clear and unambiguous language of this regulation, the Fifth Circuit, as well as the Eighth Circuit cases on which it relied, concluded that the "principles" behind Treas. Reg. § 1.817-4(d)(2)(ii) which controls the treatment of amounts paid by the assuming company in an assumption reinsurance transaction should also control the tax treatment of ceding commissions in indemnity reinsurance. *See Colonial American Life*, 843 F.2d at 205; *Prairie States Life*, 828 F.2d at 1233-34; *Modern American Life*, 830 F.2d at 113-14. In so concluding, these courts of appeals did not explain why, in drafting Treas. Reg. § 1.817-4(d), the Treasury Department and the Internal Revenue Service expressly limited the application of that regulation *solely* to assumption reinsurance. The only logical answer is that the regulation, and the "principles" underlying it, apply *only* to assumption reinsurance and *not* to indemnity reinsurance because, unlike assumption reinsurance which is treated by the Code as the acquisition of an asset, indemnity reinsurance is treated by the Code as insurance.

Thus, as the Seventh Circuit correctly concluded in *Merit Life*, 853 F.2d at 1442:

> Because substantively indemnity reinsurance is the sale of insurance by the reinsurer to the ceding company, it follows that, in addition to explicit provi-

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> (A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and
>
> (B) Treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was pa'd to the reinsured.

(Emphasis added.)

> sions of the Code and treasury regulations, the principles governing the sale of insurance, in the case of direct insurers, also apply to indemnity reinsurers.

These principles require that, in calculating gain (or loss) from operations under section 809(b), expenses incurred in issuing directly-written insurance be deducted currently and also require that expenses incurred in issuing indemnity reinsurance be deducted currently. *Infra* pp. 21-30.

C. Ceding Commissions Under Indemnity Reinsurance Are Analogous To Currently Deductible Underwriting Expenses Incurred By Primary Insurers And Are Currently Deductible

Ceding commissions incurred by a life insurance company in issuing indemnity reinsurance are analogous to agents' commissions and other expenses incurred by a life insurance company in issuing directly-written insurance. *See Colonial Surety Co. v. United States*, 178 F. Supp. 600, 602 (Ct. Cl. 1959). In each case, such expenses are incurred by the issuing compa..y in selling its insurance.[28] This has been recognized by various courts. *See Merit Life, supra*, at 1441-45; *Beneficial Life*, 79 T.C. at 645-47; *Modern Security Life*, 51 T.C.M. (CCH)

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[28] A ceding commission under indemnity reinsurance is a negotiated amount which may be calculated to take into account, *inter alia*, the ceding company's costs of issuing the insurance which is reinsured and which may also contain a profit element for the ceding company. (Tr. 36-39) *See Consumer Life*, 430 U.S. at 746, where this Court recognized that a ceding commission under indemnity reinsurance is intended "to cover the insurer's overhead." Similarly, a principal component of a direct writer's initial costs in issuing insurance is the commissions which it pays to its agents for "insurance placement services" and which also contain a profit element for such agents. *See, e.g.*, "Glossary" in *Reinsurance*, at 648 (R. Strain 1980). In both cases, the expenses are incurred with the expectation that a profit will be realized from the insurance issued. (Tr. 39-40, 51) That expectation is not necessarily realized. *See infra* note 34.

at 189; *Individual Life*, 51 T.C.M. (CCH) at 1029-30; *Colonial American Life*, 51 T.C.M. (CCH) at 1126. *See Oxford Life*, 790 F.2d at 1376.

The Tax Court has repeatedly held that ceding commissions under indemnity reinsurance are deductible as return premiums in the year incurred under section 809(c)(1).[20] That position was affirmed in *Merit Life*. The Tax Court has also concluded that ceding commissions under indemnity reinsurance are "analogous to currently deductible underwriting expenses" of primary insurers. *See, e.g., Beneficial Life, supra*, at 647. The Seventh Circuit, in *Merit Life, supra*, at 1444-45, agreed with this analogy. Since such expenses of primary insurers are indisputably part of "Other Deductions" under section 809(d)(12), the Tax Court (and the Seventh Circuit) also could have properly held that ceding commissions in indemnity reinsurance transactions are currently deductible as part of such "Other Deductions." The result for the reinsurer in calculating gain (or loss) from operations under section 809(b) is the same under either approach.

1. *Section 809(c)(1)*

Section 809(c)(1) and the regulations thereunder control the tax treatment of ceding commissions under indemnity reinsurance. Section 809(c)(1) provides that "return premiums" as well as "premiums and other consideration arising out of reinsurance ceded" are deducted from the gross amount of premiums determined thereunder.

Section 1.809-4(a)(1)(ii) of the Treasury Regulations requires that "amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums." Ceding commissions under indemnity reinsurance are "amounts of premiums or other consideration returned

[20] *Supra* note 15.

to another life insurance company in respect of reinsurance ceded." Accordingly, such commissions are included in return premiums and are therefore currently deductible in computing premium income under section 809(c)(1). *Merit Life, supra*, at 1439-40; *Beneficial Life, supra*, at 646-48; *Modern Security Life, supra*, at 189-90; *Individual Life, supra*, at 1030; *Colonial American Life, supra*, at 1127-28. *See Oxford Life, supra*, at 1376.[20]

Despite the clear and unambiguous language of the statute and the regulations, the Commissioner argued below that they could not possibly mean what they say. Specifically, the Commissioner contended that the phrase "less return premiums, and premiums and other consideration arising out of reinsurance ceded," which appears in section 809(c)(1), serves "to reduce the premium income of the primary insurer (the ceding company) —not that of the reinsurer."[21] That assertion is totally unfounded. *Merit Life, supra*, at 1439.

There is no question under the plain language of the statute, the regulations, or the legislative history[22] that

[20] In *Oxford Life*, the Court of Appeals for the Ninth Circuit addressed the issue of the tax treatment of ceding commissions under assumption reinsurance. Citing with approval the Tax Court's *Beneficial Life* opinion, the Ninth Circuit concluded that indemnity reinsurance and assumption reinsurance are treated differently by the Code and that, unlike assumption reinsurance where the initial ceding commission must be amortized over the life of the block of policies acquired, indemnity reinsurance is treated by the Code as the issuance of insurance by the reinsurer to the ceding company and therefore the reinsurer is entitled to reduce its premiums under section 809(c)(1) by the initial ceding commission it pays to the ceding company. 790 F.2d at 1376.

[21] Brief for the Commissioner to the Fifth Circuit in this case, p. 42.

[22] *See* S. Rep. No. 291, *supra*, at 21, 54, 1959 U.S. Code Cong. & Admin. News at 1595, 1629.

an indemnity reinsurer must include in premiums under section 809(c)(1) the premiums received from the ceding company to which it issues indemnity reinsurance. Nor is there any question under that language that "return premiums" as well as "premiums and other consideration arising out of reinsurance ceded" are deducted from such premiums under section 809(c)(1). If, as the Commissioner contended, Congress had intended to limit the deduction from premiums provided by section 809(c)(1) to premiums received only by primary insurers, and not indemnity reinsurers, it would have so stated. Judge Frank perhaps said it best:

> A short sentence would have done the trick. The familiar "easy-to-say-so-if-that-is-what-was-meant" rule of statutory interpretation has full force here. The silence of Congress is strident.

Commissioner v. Beck's Estate, 129 F.2d 243, 245 (2d Cir. 1942). (Footnote citation omitted.) The Commissioner has not been given authority to rewrite the law by disregarding its plain language. *See, e.g., Lewyt Corp. v. Commissioner*, 349 U.S. 237, 240 (1955); *Unexcelled Chemical Corp. v. United States*, 345 U.S. 59, 63-64 (1953).

2. *Section 809(d)(12)*

Section 809(d)(12) permits a deduction for "all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield." Thus, "ordinary and necessary" business expenses described in section 162(a) are deductible by a life insurance company under section 809(d)(12). It is beyond question that commissions and other expenses of primary insurers in issuing directly-written insurance are currently deductible under section 809(d)(12), by virtue of their being "ordinary and necessary" business expenses under section 162(a). This is true even though such commissions and other expenses "arguably might be classified as acquisition expenses to be amortized."[33] This is also true of commissions and other expenses incurred in issuing indemnity reinsurance even though the reinsurer, like the primary insurer, expects to realize a profit from the insurance it issues.[34]

Under Part I of Subchapter L, there is no distinction between directly-written insurance and indemnity reinsurance; each is treated as insurance by the Code. Nor does the pattern for taxing life insurance companies prescribed by the Code distinguish between the expenses of issuing directly-written insurance and the expenses of issuing indemnity reinsurance. In each case, the Code allows a life insurance company, in computing gain (or loss) from operations under section 809(b), to reduce currently its underwriting income by the expenses in-

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[33] H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1428, *reprinted in* 1984 U.S. Code Cong. & Admin. News 697, 1073; S. Prt. No. 169 (Vol. I), 98th Cong., 2d Sess. 555 (1984). The House Committee on Ways and Means and the Senate Committee on Finance each restated this rule of Part I of Subchapter L when Congress enacted provisions in DEFRA that changed (effective 1984) certain sections of the Code which had been enacted as part of the 1959 Act:

> The change [DEFRA] from present law [1959 Act] was intended to reinforce the primacy of the Federal tax rules and not impose a new method of tax accounting on life insurance companies. *Thus, for example, agents' commissions paid by direct insurers would continue to be treated as sales expenses and deductible when paid, as has been allowed historically (even though they arguably might be classified as acquisition expenses to be amortized).*

Id. (Emphasis added.) *See also* General Explanation, *supra*, at 621.

[34] Of course, even though a primary insurer or an indemnity reinsurer may *expect* to realize a profit from the insurance each issues, this does not mean that each will in fact realize a profit. To the contrary, each may realize a loss.

curred in issuing such insurance.[35] This result is precisely what Congress envisioned when it passed the 1959 Act.[36]

D. NAIC Accounting, Which Requires That Ceding Commissions Under Indemnity Reinsurance Be Deducted Currently, Is Controlling For Tax Purposes

The rules Congress provided in the 1959 Act for taxing life insurance companies were based on the Annual Statement accounting prescribed for life insurance companies by the National Association of Insurance Commissioners. Section 818(a).[37] In enacting Part I of Sub-

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[35] *See Merit Life*, 853 F.2d at 1438-40, 1443-45; cases cited *supra* note 15. *See also Oxford Life*, 790 F.2d at 1376.

[36] H.R. Rep. No. 34, 86th Cong., 1st Sess. 3-4, *reprinted in* 1959-2 C.B. 736, 738; S. Rep. No. 291, *supra*, at 6-7, 38-39, 1959 U.S. Code Cong. & Admin. News at 1581-82, 1613-14. Thus, Congressman Wilbur Mills, in discussing the 1959 Act on the floor of the House of Representatives, stated:

> [T]ypically life insurance companies show a loss from operation in their early years by charging off as an expense in those years many of the costs associated with income that will be received in later years. 105 Cong. Rec. 10412 (1959).

See also H.R. Rep. No. 34, *supra*, at 4, 1959-2 C.B. at 738 ("Many small, new and growing life insurance companies have underwriting losses rather than gains because of the additional initial costs they incur (such as agents' commissions) in placing the new policies on their books."); S. Rep. No. 291, *supra*, at 7, 1959 U.S. Code Cong. & Admin. News at 1582 ("The small, new, and growing life insurance companies are particularly likely to have underwriting losses because of the initial costs which they incur (such as agents' commissions) in placing new policies on their books.").

[37] Section 818(a) provides—

> (a) All computations entering into the determination of the taxes imposed by this part shall be made—
>
> (1) under an accrual method of accounting, or
>
> (2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).
>
> *Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.*

(Emphasis added.)

chapter L, Congress intended that the net gain from operations reflected in the Annual Statement in the "Summary of Operations" be the starting point for calculating gain (or loss) from operations for federal tax purposes.[38] "Gain from operations" is a term of art which appears outside of section 809(b) only in NAIC accounting and is clearly derived from the page of the Annual Statement designated "Summary of Operations."[39]

When Congress enacted Part I of Subchapter L, it was fully aware of NAIC Annual Statement accounting practices, including the NAIC requirement that, in calculating net gain from operations, commissions incurred in issuing insurance, both directly-written insurance and

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[38] For example, the Secretary of the Treasury wrote Congress:

> We suggest that the starting point for measuring the net earnings should be the figure for "Net gain from operations after dividends to policyholders" which appears in each company's annual statement to the State insurance departments and which summarizes the operating results for the year. *This figure is based on carefully developed life insurance accounting practices which have general acceptance in the industry.*

Taxation of Income of Life Insurance Companies: Hearings Before the Subcomm. on Internal Revenue Taxation of the House Comm. on Ways and Means, 85th Cong., 2d Sess. 4 (1958); Tax Formula for Life Insurance Companies: Hearings on H.R. 4245 Before the Senate Comm. on Finance, 86th Cong., 1st Sess. 512 (1959) (Statement of Robert B. Anderson, Secretary of the Treasury). (Emphasis added.)

[39] Net gain from operations was first reflected in the Annual Statement (page 4) in the "Summary of Operations" in 1951.

indemnity reinsurance, be deducted currently.[40] Although the final language of Part I of Subchapter L reflected a number of specific modifications of net gain from operations as shown in the NAIC Annual Statement, disallowing a current deduction for commissions on indemnity reinsurance in determining gain (or loss) from operations under section 809(b) was *not* among these specific modifications. Since there is no provision in Part I of Subchapter L requiring deviation for federal tax purposes from the manner in which such commissions are taken into account in the computation of net gain from operations in the Annual Statement, it is reasonable to conclude that Congress intended the NAIC accounting approach to be followed for purposes of calculating gain (or loss) from operations under section 809(b).[41] Any other conclusion would be contrary to section 818(a).

Section 818(a) has been interpreted by this Court to require use of NAIC accounting "except when the rules of accrual accounting dictate a contrary result . . . ." *Standard Life*, 433 U.S. at 159. There are no rules of accrual accounting which dictate a result contrary to NAIC accounting in the present case. The rules of accrual accounting do not speak to the question of the character, as a currently deductible expense or as an amortizable capital expenditure, of the ceding commission a company incurs in issuing the form of insurance

[40] Since 1951, the current deduction of commissions incurred in issuing insurance, both directly-written insurance and indemnity reinsurance, has consistently been required by NAIC accounting. In fact, from 1951 through 1974, all commissions incurred in issuing insurance were reported on the same line in the Annual Statement (line 21, page 4). It was not until 1975 that the NAIC first required life insurance companies to report commissions on directly-written insurance and on indemnity reinsurance on separate lines of the Annual Statement (line 21, page 4 and line 21A, page 4, respectively).

[41] In contrast, as is made clear in Treas. Reg. § 1.817-4(d)(2)(ii), Part I of Subchapter L treats assumption reinsurance as the acquisition of insurance policies and requires that the commissions incurred by the assuming company in an assumption reinsurance transaction be capitalized and deducted over the estimated life of such acquired insurance policies, regardless of the treatment prescribed by NAIC accounting for such commissions.

known as indemnity reinsurance. *Merit Life*, 853 F.2d at 1444. Nor do accrual accounting rules address the character, as a currently deductible expense or as an amortizable capital expenditure, of the commissions and other expenses a life insurance company incurs in issuing directly-written insurance. Accordingly, since accrual accounting rules do not require a result contrary to (and are not inconsistent with) NAIC accounting, section 818(a) requires NAIC accounting to control for federal tax purposes.[42] *See Standard Life*, 433 U.S. at 158-59,

[42] This was recently confirmed in a report prepared by the staff of the Joint Committee on Taxation, in conjunction with the staff of the House Committee on Ways and Means, which described possible options for increasing revenues. In proposing as one possible option the requirement that agents' commissions no longer be deducted currently but be capitalized and amortized over the period of coverage under the insurance policy (or, alternatively, over some other fixed period of years), the staffs noted that, to implement such an option, it would be necessary to amend present tax law which mandates that NAIC Annual Statement accounting be followed. Thus, the report states:

> Under present law, a life insurance company generally computes its tax liability by using the accrual method of accounting, or (to the extent permitted in regulations) by using a combination of the accrual method with another method (but not the cash method). All computations, however, to the extent not inconsistent with Federal tax accounting rules, are made in a manner consistent with the manner required for accounting on the annual statement approved by the National Association of Insurance Commissioners ("NAIC"). *Consistent with the annual statement reporting requirements, life insurance companies generally deduct agents' commissions when paid.* (Emphasis added.)

Staff of the Joint Comm. on Taxation, in conjunction with the Staff of the House Comm. on Ways and Means, 99th Cong., 1st Sess. 238, Description of Possible Options to Increase Revenues Prepared for the Comm. on Ways and Means (Comm. Print 1987).

162. NAIC accounting requires the current deduction of ceding commissions incurred in connection with issuing indemnity reinsurance.

This Court should give effect to the NAIC accounting on which Congress based the taxation of life insurance companies and should hold, as the Tax Court and the Seventh Circuit have held, that expenses incurred in the issuance of indemnity reinsurance, like expenses incurred in issuing directly-written insurance, are currently deductible.

CONCLUSION

The judgment of the court of appeals should be reversed and the case should be remanded with instructions to affirm the Tax Court's judgment.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether "ceding commissions" payable by a reinsurer to the initial insurer as consideration for the right to share in the future income stream from a block of life insurance policies reinsured under contracts of indemnity reinsurance are fully deductible in the year paid, or, instead, whether such payments must be capitalized and amortized over the estimated life of the reinsurance agreements.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-9a) is reported at 843 F.2d 201. The opinion of the Tax Court (Pet. App. 11a-22a) is unofficially reported at 51 T.C.M. (CCH) 1123.

JURISDICTION

The judgment of the court of appeals was entered on April 26, 1988. A petition for rehearing was denied on May 25, 1988 (Pet. App. 23a). The petition for a writ of certiorari was filed on August 22, 1988. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Sections 809 and 818 of the Internal Revenue Code of 1954 (26 U.S.C.) and Section 1.809-4 of the Treasury

Regulations on Income Tax (26 C.F.R.), as in effect for 1975 and 1976, are set forth in pertinent part in a statutory appendix (App., *infra,* 1a-3a).

STATEMENT

1. Petitioner is a Louisiana corporation engaged in the business of writing and reinsuring life, accident, and health insurance contracts. During the years at issue, it qualified for federal income taxation as a "life insurance company" under Section 801 of the Internal Revenue Code.[1] In 1975 and 1976, petitioner entered into four indemnity reinsurance agreements with respect to a block of life insurance policies written by Transport Life Insurance Company. In these agreements, petitioner agreed to reinsure the aggregate total of 76.6% of Transport's liabilities under that block of policies by indemnifying Transport for that portion of its losses.[2] Some of the reinsurance was accomplished by means of conventional coinsurance agreements, while the bulk of the reinsurance was ac-

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect in 1975 and 1976, the years at issue (the Code or I.R.C.).

[2] In indemnity reinsurance of the types involved here, the initial insurer and the reinsurer agree to share the premiums, expenses, and liabilities on a block of existing policies. The reinsurer in "indemnity reinsurance" does not become directly liable to policyholders, but agrees only to indemnify the initial insurer for its losses; the initial insurer continues to receive premiums and to pay expenses and benefits to the policyholders. This method of reinsurance contrasts with "assumption reinsurance," in which the reinsurer, in effect, steps into the shoes of the issuing company with respect to the policies, becoming directly liable to the policyholders and directly entitled to premium payments made by them. See generally Pet. App. 2a-4a; *Modern American Life Ins.* v. *Commissioner,* 830 F.2d 110, 110 n.2 (8th Cir. 1987).

complished by means of modified coinsurance agreements.[3] Under both forms of reinsurance, petitioner became entitled to 76.6% of the future premiums (less expenses) received on the policies. Pet. App. 2a, 4a-5a. Transport had the right to reacquire portions of the ceded business at scheduled intervals (*id.* at 6a).

The agreements provided that Transport was to pay "reinsurance premiums" to petitioner equal to the amount of the reserves required to be established by petitioner to cover the conventional coinsurance liability for this block of policies.[4] These reinsurance premiums were $675,762 for the 1975 agreements, and $851,398 for the 1976 agreements. The agreements separately provided that petitioner was to pay "ceding commissions" to Transport of $680,000 for the 1975 agreements and $852,000 for the 1976

[3] Under the "conventional coinsurance" agreements, which covered 6.6% of the policies, petitioner established its own reserves to cover the reinsured liability and Transport reduced its reserves accordingly. Under the "modified coinsurance" agreements, covering 70% of the policies, Transport continued to maintain the required reserves and was required to collect and pay over to petitioner the investment income derived from the assets supporting those reserves.

[4] Initial reinsurance premiums were provided for only in the conventional coinsurance agreements (covering 6.6% of the block). There were no reinsurance premiums called for in the modified coinsurance agreements (covering 70% of Transport's rights and liabilities on the block), because Transport retained all assets corresponding to the reserve liabilities reinsured under those agreements. The combined effect of the conventional and modified coinsurance agreements was simply to allow a netting of payments so that virtually no cash changed hands. See Tr. 35. The parties, however, elected to have the modified coinsurance transactions treated for tax purposes as if they were conventional coinsurance agreements (see Section 820 of the Code (repealed in 1984)). Therefore, petitioner was treated for tax purposes as having received reinsurance premiums under those agreements also, in the amount of the reserve liabilities attributable to the reinsured risks. See Pet. App. 6a.

agreements, in consideration for the future premium income acquired. These offsetting obligations were netted against each other before payment, with the result that petitioner paid Transport $4,238 in 1975 and $602 in 1976. In addition, petitioner paid a finder's fee of $13,600 in 1975. Pet. App. 4a-5a.

On its federal income tax returns for 1975 and 1976, petitioner sought to deduct the full amount of the "ceding commissions," as well as the finder's fee, in the years of payment. Thus, petitioner reported tax losses of $693,600 for 1975 and $852,000 for 1976 as a result of the reinsurance transactions, although petitioner had entered into those transactions fully expecting that they would be profitable.[5] The Commissioner disallowed the deductions claimed for the ceding commissions and finder's fee. The Commissioner determined that these amounts represented the acquisition costs for economic benefits having a useful life beyond the year of payment—namely, the right to petitioner's share of the future income stream earned from the reinsured policies. Accordingly, the Commissioner concluded that the ceding commissions should be capitalized and amortized over the period of indemnification (which was later stipulated to be seven years (Pet. App. 9a n.6)). *Id.* at 2a, 6a, 16a.

2. Petitioner filed a petition in the Tax Court seeking redetermination of the resulting deficiencies, and the Tax Court ruled in its favor (Pet. App. 11a-22a). Relying on its prior decision in *Beneficial Life Ins. Co.* v. *Commissioner*, 79 T.C. 627 (1982), the court held that ceding commissions

[5] The other aspects of the reinsurance transactions generated no taxable gain or loss to petitioner. The reinsurance premiums received by petitioner from Transport were reported as income, but those amounts were exactly offset by deductions allowed for the concomitant increase in petitioner's reserve liabilities for the reinsured policies. Pet. App. 6a.

paid to the reinsured company in indemnity reinsurance transactions may be deducted in full in the year of payment (Pet. App. 16a-22a). The court viewed an indemnity reinsurance transaction not as a sale of intangible assets, but as the initial insurer's purchase of insurance from the reinsuring company. On that view, the court reasoned, petitioner could reduce its income by the amount of the ceding commissions under the Code's allowance for "return premiums, and premiums and other consideration arising out of reinsurance ceded" (see Section 809(c)(1)).[6] Pet. App. 17a-18a. The Tax Court acknowledged that ceding commissions paid in connection with an assumption reinsurance transaction would have to be capitalized and amortized over the estimated life of the policies involved, but it justified this apparent inconsistency as being required by the Code itself on the ground that the Code "treats an assumption reinsurance transaction as a sale by the initial insurer to the reinsuring company" (*id.* at 17a).

3. The court of appeals reversed (Pet. App. 1a-9a). Agreeing with the Eighth Circuit's decisions in *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110 (1987), and *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (1987), the court held that the ceding commissions reflected petitioner's acquisition costs for the intangible right to future income obtained under the indemnity reinsurance agreements, and therefore were not fully deductible in the year of payment. The court found con-

[6] The provisions of the Code pertaining to the taxation of life insurance companies were substantially revised by Section 211 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 720. Section 809(c)(1) is carried forward in the revised provisions in substantially the same form in Section 803(a)(1) and (b) of the amended Code, which applies to tax years beginning after December 31, 1983. The question presented in this case was not addressed by Congress in the revision and does not appear to have been affected.

trolling the "fundamental rule that an amount expended to acquire an asset or economic interest, benefit or advantage with an income producing life extending substantially beyond the current taxable year may not be [expensed] in the year of payment but must be depreciated or amortized over its useful life" (*id.* at 7a-8a). Applying that rule to the transactions here, the court concluded, required that the ceding commissions be amortized over the useful life of the policies (*ibid.*).

The court of appeals specifically rejected the Tax Court's view that indemnity reinsurance should be treated differently from assumption reinsurance with respect to ceding commissions (*id.* at 9a). In particular, the court criticized the view that indemnity reinsurance is more analogous to the issuance of new insurance, in which underwriting expenses are currently deductible. The court found its earlier analysis in the assumption reinsurance context to be equally applicable here, concluding that the ceding commission " 'in no way represents the cost of putting the business on the books of the company. It represents instead, an estimate of the current value to the taxpayer that is represented by having these policies on its books with the expectation of the continuing premiums to be paid in the future.' " Pet. App. 9a (quoting *Southwestern Life Ins. Co.* v. *United States*, 560 F.2d 627, 640-641 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978)). The court also determined that neither Section 809(c)(1) nor any other section of the Code overrode the basic capitalization rules that otherwise control this case and that require amortization of ceding commissions (Pet. App. 8a).[7]

[7] The court of appeals further held that the $13,600 finder's fee must also be capitalized and amortized over the life of the policies (Pet. App. 9a). The Tax Court had upheld the immediate deduction of the finder's fee, mistakenly stating that the Commissioner had conceded that the finder's fee should be currently deductible if the ceding commissions were held to be currently deductible (*id.* at 22a).

SUMMARY OF ARGUMENT

The ceding commissions paid by petitioner represent its acquisition costs for an intangible asset—namely, a future income stream generated by the reinsured policies. Any other taxpayer, in any other setting, would have to capitalize that expense as the acquisition cost of an intangible asset or interest with an income-producing life extending substantially beyond the current tax year, and would have to amortize that cost over the appropriate period. The same result is also required in this case.

1. Indemnity reinsuance of the sort involved here is a vehicle by which one insurance company shifts some of the risks on policies it has written to another insurance company—the reinsurer. In that transaction, the reinsured company gives up a share of the future income from all or part of a block of policies, and the reinsurer agrees to indemnify the reinsured company for the same percentage of losses incurred on the block. To acquire that future income, the reinsurer pays the initial insurer an up-front "ceding commission." Under long established tax principles, that acquisition cost must be capitalized and amortized over the indemnification period.

It is undisputed that ceding commissions payable by a reinsurer to a reinsured company in the case of *assumption* reinsurance must be capitalized as the cost of acquiring intangible assets. The same result should follow here. Indemnity reinsurance differs in some respects from assumption reinsurance, but none of those distinctions is germane to the tax treatment of ceding commissions. The pivotal fact that is common to both is that the reinsurer makes a payment to acquire the right to a future stream of

income from the reinsured policies. The purpose of paying up-front ceding commissions in either case, quite simply, is to purchase that profitable right.

Permitting a current deduction of ceding commissions would grossly distort petitioner's income by mismatching the income to be derived from the reinsured policies over future years and the current costs of acquiring that income. There is no reason to believe that Congress intended to permit indemnity reinsurers to distort their income in this way, which would drastically depart from basic tax principles applicable to all other taxpayers (including assumption reinsurers) who make current expenditures for future benefits.

2. The specific provisions of the Code that govern life insurance companies in no way override the basic rules of capitalization and amortization of acquisition expenses as applied to ceding commissions. Contrary to petitioner's argument, Section 809(c)(1), which allows the subtraction from "gross premiums" of "return premiums, and premiums and other consideration arising out of reinsurance ceded," does not permit the immediate deduction of the ceding commissions here. When read in context, it is apparent that Section 809(c)(1) was designed only to ascertain an insurance company's true premium income. It does this by allowing appropriate adjustments to gross premium receipts for amounts that ultimately do not "belong" to the company that receives them, but instead must be returned to the policyholder or paid over to another company. Section 809(c)(1) therefore does not apply to ceding commissions, which are paid for the right to share in the ceding company's future premium income.

Ceding commissions are not "return premiums" within the meaning of Section 809(c)(1) or its associated regulation. A ceding commission is paid contemporaneously

with the closing of the reinsurance transaction, and there is no sense in which this up-front capital outlay is being "returned" to the ceding company. Nor are ceding commissions "consideration arising out of reinsurance ceded." That branch of Section 809(c)(1) permits only the *ceding company* to deduct from its gross premiums amounts it pays to a reinsurer to obtain indemnity reinsurance. The subtraction of ceding commissions from gross premiums that petitioner seeks is thus incompatible with the language and purposes of Section 809(c)(1).

3. Petitioner is also wrong in arguing that Congress intended ceding commissions to be deductible under Section 809(d)(12) as "ordinary and necessary" expenses, just as agent's commissions are currently deductible upon the sale of a single insurance policy. Section 809(d)(12) of the Act embraces only the usual range of "ordinary and necessary" deductions, and that provision in no way comprehends the capital payments embodied in a ceding commission. A ceding commission has no kinship to an agent's commission, other than the colloquial designation of both as "commissions." A ceding commission does not compensate anyone for personal services in selling a policy, but is paid for the right to share in future income from an intangible asset—a block composed of thousands, perhaps hundreds of thousands, of insurance policies. Indeed, the ceding commission is paid not to an agent or employee, but to the ceding company, which stands in the place of the policyholder in its relationship to the reinsurer.

4. Section 818(a) of the Act also affords no grounds for deduction of the ceding commissions. That provision specifies that federal income tax computations for life insurance companies shall be consistent with those prescribed for annual statement purposes by the National Association of Insurance Commissioners (NAIC), *except* when the rules of accrual accounting dictate a contrary

result. This exception is directly applicable here because accrual accounting mandates the amortization of the acquisition costs of a capital asset.

ARGUMENT

I. FUNDAMENTAL PRINCIPLES OF TAXATION REQUIRE CAPITALIZATION AND AMORTIZATION OF CEDING COMMISSIONS

Reinsurance transactions like the ones involved here are commonly employed in the life insurance industry, and they serve useful purposes for both the initial insurer and the reinsurer. From the initial insurer's perspective, reinsurance reduces or eliminates the risk associated with a block of policies it has issued by passing on part or all of the initial insurer's liability to the reinsurer. Reinsurance can also serve a financing purpose for the initial insurer by reducing the drain on its surplus from the expenses of writing new policies (see Pet. App. 2a n.2). From the reinsurer's perspective, however, the transaction serves one basic economic purpose. Reinsurance allows the reinsurer to acquire a future stream of income from the block of policies reinsured, consisting largely of future premiums to be paid on those policies. Because reinsurers anticipate a future profit from the policies they agree to reinsure, they are willing to make a sizeable up-front payment to the initial insurer for the right to share in the income.

The tax treatment of that payment, called a "ceding commission," is at issue in this case. It is undisputed that petitioner is entitled to deduct this payment; the issue is essentially one of timing. Petitioner asserts that the ceding commission can be deducted in full in the year of payment, even though that deduction would generate a substantial immediate tax loss on the reinsurance transaction. The court of appeals, on the other hand, sustained

the IRS's position that the ceding commission must be capitalized and amortized over the income-producing life of the block of policies reinsured (see I.R.C. § 167).

Though the Code contains many special provisions applicable to life insurance companies, this case is controlled by principles that govern all taxpayers. It is hornbook law that a taxpayer cannot deduct in the year of payment the cost of acquiring an income producing interest, tangible or intangible, with a useful life extending substantially beyond the taxable year. Instead, the acquisition cost must be capitalized and amortized over an appropriate period. Application of that principle compels the conclusion that ceding commissions, which represent the acquisition cost of an intangible right to income stretching many years into the future, must be capitalized and amortized over the life of the policies reinsured—both in the assumption reinsurance context, where the issue is well settled, and in the indemnity reinsurance context involved here.

A. Ceding Commissions in Both Indemnity Reinsurance and Assumption Reinsurance Transactions Are Paid to Acquire an Intangible Right in a Block of Policies, Which Is Expected To Produce Income Over Future Periods

There are several varieties of reinsurance transactions, all of which share the common element of allowing the reinsured to pass on all or part of the liability on its policies to the reinsurer. These transactions are generally divided into two broad categories: assumption reinsurance and indemnity reinsurance.

In assumption reinsurance, the reinsurer takes over all or part of the insurance business of the reinsured or ceding company and becomes directly liable to the policyholders involved for the liabilities it has assumed. In return for being relieved of liability, the initial insurer ordinarily transfers to the reinsurer a commensurate portion of the

assets backing the reserves it has established out of past premiums, and the reinsurer sets up its own reserves to cover the payment of future policy benefits. See D. McGill, *Life Insurance* 431-432 (1967).[8] Thereafter, the reinsurer treats the policies as its own, earning income from premium receipts and the investment interest on the assets backing the reserves, and ultimately recapturing any excess reserves not needed to pay benefits.

Assumption reinsurers compensate the ceding company for the right to obtain the future income from the block of policies. The consideration paid in such a transaction depends upon the maturity of the policies in question and the parties' perception of their future profitability. When the parties believe that future premiums are likely to be more than sufficient to cover projected liabilities, the reinsurer ordinarily will not insist on the full transfer of the assets corresponding to the reinsured's reserves, but will agree to pay the initial insurer consideration for the opportunity to receive the projected profits on those policies. See *Southwestern Life Ins. Co.* v. *United States,* 560 F.2d

[8] In transferring assets covering its reserves, the initial insurer may very well be relinquishing a built-in profit to the reinsurer. The profit element in the reserves arises from the fact that state law generally requires insurance companies to make conservative assumptions about mortality and investment gains. See, *e.g.*, Tr. 49-50. This has the effect of inflating the reserves beyond what is actually necessary to pay the future benefits covered by the reserves. Insurance companies recapture this "hidden profit" when the liability for benefits associated with the reserves is extinguished. The Eighth Circuit recognized this point in discussing the potential financial rewards for a reinsurer (there, in an indemnity transaction): "The block of reinsurance acquired by taxpayer has positive economic value precisely because the required reserves exceed the true economic liabilities on the underlying policies." *Prairie States,* 828 F.2d at 1231. "As the policies mature and benefits are paid," the court explained, "there will be excess funds remaining in the reserve when all of taxpayer's obligations with respect to the reinsured policies have been fully performed" (*ibid.*).

627, 640 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978). The payment from the reinsurer to the initial insurer is called a ceding commission. It is well settled that this ceding commission is not immediately deductible, but rather must be amortized over the period during which the policies are expected to produce future income. See note 12, *infra.* In sum, an assumption reinsurance transaction takes the initial insurer out of the picture entirely on a block of insurance business, and the reinsurer pays a ceding commission that represents the price of obtaining that business.

The broad category of indemnity reinsurance consists of several different types of transactions. All of them differ from assumption insurance in one respect—the reinsurer does not become directly liable to policyholders with respect to the reinsured liability, but agrees only to indemnify the ceding company for all or part of its losses on a block of policies. The initial insurer remains as a conduit between the policyholders and the reinsurer (by continuing to service the policies, collect premiums, and pay benefits). The initial insurer may also have the right to recapture all or part of the reinsured risks. See generally McGill, *supra,* at 432-434. In other respects, however, indemnity insurance may be similar to assumption reinsurance.

The simplest form of indemnity reinsurance is risk premium (or "yearly renewable term") reinsurance, which is similar to a traditional insurance contract. The initial insurer simply pays a premium to the reinsurer for protection against identified losses under policies it has directly written, and the reinsurer sets up its own reserves to cover the reinsured risks. See S. Rep. No. 291, 86th Cong., 1st Sess. 39 (1959); D. McGill, *supra,* at 435-437. There is no apparent reason for the payment of a "ceding commis-

sion" by the reinsurer in this type of transaction, and hence it does not involve the tax question at issue here.

The type of indemnity insurance involved in this case, coinsurance, is much more analogous to assumption reinsurance. Conventional coinsurance involves a kind of sharing arrangement under which the initial insurer and the reinsurer share in the liabilities and profits generated by the reinsured policies. Apart from the differences in the duration and form of the transactions—namely, that the reinsurer does not become directly liable to the policyholders or collect premiums directly from them—the assumption reinsurer and the coinsurance reinsurer have essentially the same financial benefits and obligations. In both cases, the reinsurer must carry the reserves to cover its specified share of the liabilities and ordinarily acquires the right to a concomitant share of the future premiums to be paid on the reinsured policies. And in both cases, a ceding commission is paid by the reinsurer to the reinsured for the right to share in the future income stream.[9]

The taxation of life insurance companies is governed by the intricate provisions of Sections 801-820 of the Code. In 1959, those provisions were amended to tax life insurance companies, not only on investment income, but also on underwriting gains derived from premium income. See *Commissioner* v. *Standard Life & Accident Ins. Co.*, 433

[9] Some of the transactions in this case were "modified coinsurance" transactions in which the ceding company continues to maintain the entire reserve, though it is entitled to indemnification for a specified percentage of losses and obligated to remit to the reinsurer a corresponding share of investment and premium income (see note 3, *supra*). See D. McGill, *supra,* at 438-440. Since the parties availed themselves of the Section 820 election, the transactions were treated for tax purposes as though each was a conventional coinsurance transaction. See note 4, *supra; United States* v. *Consumer Life Ins. Co.*, 430 U.S. 725, 747-748 (1977).

U.S. 148, 152-154 (1977). The provisions establish a complex, three-phase system for calculating a company's income. See generally *United States* v. *Atlas Life Ins. Co.*, 381 U.S. 233, 235 n.2 (1965). This case does not implicate the details of that calculation. The question here concerns the treatment of ceding commissions in connection with the reinsurer's "gain from operations," specifically, the calculation of its adjusted gross premium income under Section 809(c)(1). That Section provides for the inclusion in gain from operations of "[t]he gross amount of premiums and other considerations * * * less return premiums, and premiums and other consideration arising out of reinsurance ceded."

Petitioner contends that it is entitled to deduct its ceding commissions under this provision as offsets against gross premiums in the years of payment. That would entitle it to immediate tax deductions of $693,600 in 1975 (including the finder's fee) and $852,000 in 1976, even though these amounts were paid to obtain valuable economic interests with useful lives of seven years. The claimed deductions would generate substantial tax losses on these reinsurance transactions that would be available to offset petitioner's income from other underwriting activities. The court of appeals rejected petitioner's contention and correctly held that ceding commissions paid by indemnity reinsurers represent the acquisition costs of intangible assets that, under general tax principles, must be capitalized and amortized over the period of indemnification.

B. The Tax Treatment of Ceding Commissions Paid by an Indemnity Reinsurer Is Governed by the Rule that Costs Incurred To Acquire an Economic Interest Expected To Produce Income for Substantially More than One Year May Not Be Expensed in the Year of Payment but Must Be Capitalized and Amortized over the Interest's Useful Life

1. A fundamental premise of the tax law is that an amount expended to acquire an asset or economic interest, benefit, or advantage with an income-producing life extending substantially beyond the current taxable year may not be deducted in the year of payment but must be capitalized and amortized over its useful life. See I.R.C. § 263; *Commissioner* v. *Idaho Power Co.*, 418 U.S. 1, 12 (1974); *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345 (1971); *Commissioner* v. *Tellier*, 383 U.S. 687, 689-690 (1966); See generally 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶¶ 20.4, 23.1.1, 23.2.6 (1981). That rule of law applies equally to the acquisition of any interest—tangible or intangible—that is expected to contribute to income in future taxable periods. See, *e.g.*, *Woodward* v. *Commissioner*, 397 U.S. 572 (1970) (professional fees expended in the appraisal of stock must be capitalized).[10]

[10] See also *Frantz* v. *Commissioner*, 784 F.2d 119, 123 (2d Cir. 1986), cert. denied, 107 S. Ct. 3262 (1987); *Sears Oil Co.* v. *Commissioner*, 359 F.2d 191, 197 (2d Cir. 1966) ("The test for determining whether items should be treated as a current expense or a capital expenditure is whether utility of expenditure survives the accounting period."); *Falstaff Beer, Inc.* v. *Commissioner*, 322 F.2d 744, 747 (5th Cir. 1963); *United States* v. *Wheeler*, 311 F.2d 60, 61-64 (5th Cir. 1962); cert. denied, 375 U.S. 818 (1963); *Darlington-Hartsville Coca-Cola Bottling Co.* v. *United States*, 393 F.2d 494, 496 (4th Cir. 1968), cert. denied, 393 U.S. 962 (1968); *Encyclopeadia Britannica, Inc.* v. *Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982); *Wells-Lee* v. *Commissioner*, 360 F.2d 665, 669-670 (8th Cir. 1966); *United States* v. *Akin*, 248 F.2d 742, 744 (10th Cir. 1957), cert. denied, 355 U.S. 956 (1958).

The ceding commissions here clearly fall within the scope and rationale of this principle. As petitioner's own expert witness essentially admitted at trial (Tr. 56-57), petitioner paid its ceding commissions to acquire an economic benefit that it fully expected to contribute to its income in future periods. In all four indemnity reinsurance transactions here, the ceding commissions paid by petitioner represented a capital investment in the reinsured policies and, therefore, are properly amortizable over the indemnification period. Departing from the basic capitalization rules, as petitioner urges, would grossly distort its income. A current deduction would mismatch the future income to be derived from the reinsured policies with the current costs of acquiring the right to that income. Such an accelerated deduction of expenses incurred to obtain future income would undermine the basic purpose of capitalization rules—to "mak[e] a meaningful allocation of the cost entailed in the use * * * of the asset to the periods to which it contributes [income]." *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 104 (1960).

The courts of appeals that have considered this issue generally have recognized that an indemnity insurer's ceding commission is inherently capital in nature. In *Modern American Life Ins. Co.* v. *Commissioner*, 830 F.2d 110, 112 (8th Cir. 1987), the court explained that "[i]t is apparent that taxpayer, in paying $450,000 in return for the right to a percentage of the future earnings on the reinsured policies, acquired an economic benefit that it fully expected to contribute to its income in future periods." See also *Prairie States Life Ins. Co.* v. *United States*, 828 F.2d 1222, 1231 (8th Cir. 1987) (reinsurer took on the transaction to acquire an "intangible asset" with future benefit). The court of appeals in the present case also correctly recognized that the ceding commission is an expense reflecting "an estimate of the current value to the taxpayer

that is represented by having these policies on its books with the expectation of continuing premiums to be paid in the future" (Pet. App. 9a). See also *Southwestern Life Ins. Co.* v. *United States,* 560 F.2d 627, 640-641 (5th Cir. 1977), cert. denied, 435 U.S. 995 (1978); but see *Merit Life Ins. Co.* v. *Commissioner,* 853 F.2d 1435, 1441-1442 (7th Cir. 1988), petition for cert. pending, No. 88-955. That is precisely the kind of expense that must be capitalized, rather than immediately written off. Indeed, this conclusion is confirmed by a published independent accounting guide for auditing insurance companies, which states that a ceding commission "should be treated as an acquisition expense to be amortized over the premium-paying period" (*The Industry Audit Guide of Stock Life Insurance Companies,* prepared by the Committee on Insurance Accounting and Auditing of the American Institute of Certified Public Accountants, 92 (1972)).

Petitioner seeks (Br. 21 n.28) to explain away the ceding commissions as merely a form of reimbursement to the initial insurer for expenses it incurred in selling the underlying policies. But the motives that impel the initial insurer to seek the payment of a ceding commission cannot account for the willingness of the indemnity reinsurer to pay it. There is no adequate explanation for petitioner's paying a ceding commission—and thus taking on future liability far in excess of the net assets it received from Transport—except to purchase the share of future profits from the block of policies reinsured. Thus, regardless of whether the *ceding* company views the commissions as a partial reimbursement of its selling expenses, the critical fact here is that to the *reinsurer,* such ceding commissions represent the cost of an intangible right to a share of the

future income from the reinsured policies.[11]

2. It is now well settled that capitalization and amortization are required for ceding commissions that the reinsuring company expressly agrees to pay in an assumption reinsurance transaction.[12] Because there is essentially no

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[11] The situation is analogous to the purchase of a typewriter, a manufacturing plant, or, for that matter, an intangible asset such as a patent, by a business. The seller may reasonably view the price as reimbursement for his deductible expenses incurred to produce the asset, but there can be no doubt that the purchaser has paid for an asset with a useful life in excess of one year and it must capitalize, not immediately deduct, the cost of the asset. Petitioner essentially admits the capital nature of the transaction when it acknowledges (Br. 25) that "the reinsurer, like the primary insurer, expects to realize a profit from the [indemnity] insurance it issues." Petitioner's attempted qualification of this point—noting that it may actually experience an unanticipated loss (*id.* at 25 n.34)—is unavailing. That there is an element of risk or that the reinsurer may misjudge the benefits of the transaction is entirely irrelevant to understanding its business purpose at the outset when it pays for the right to share the benefits from the block of policies.

[12] See *Southwestern Life Ins. Co.* v. *United States,* 560 F.2d at 640-641 (requiring capitalization of payment that reinsurer agrees to pay to the reinsured company); *Standard Life & Accident Ins. Co.* v. *Commissioner,* 525 F.2d 786, 791 (10th Cir. 1975) (same), rev'd on other grounds, 433 U.S. 148 (1977); *Mutual Savings Life Ins. Co.* v. *United States,* 488 F.2d 1142, 1146-1147 (5th Cir. 1974) (the Florida Life transaction) (same)); *Oxford Life Ins. Co.* v. *United States,* 790 F.2d 1370, 1376 (9th Cir. 1986) (requiring capitalization of payment *to* ceding company that reinsurer agreed to net against a greater amount of consideration payable *by* the ceding company); *Kentucky Central Life Ins. Co.* v. *Commissioner,* 57 T.C. 482 (1972) (same). Such treatment is required by Section 1.817-4(d) of the Treasury Regulations on Income Tax. Some courts have, incorrectly in our view, reached a dif-

economic difference between a ceding commission paid in an assumption reinsurance transaction and one paid in an indemnity reinsurance transaction, the same capitalization rule should apply here. See *Idaho Power*, 418 U.S. at 14 (rejecting capitalization rule that would "lead to disparate treatment among taxpayers" who incur comparable expenses). Indeed, even the Tax Court acknowledged in *Beneficial Life Ins. Co.* v. *Commissioner*, 79 T.C. at 646-647, that it might "seem strange at first for * * * [assumption and indemnity reinsurance transactions] to have such different tax consequences when they are, at heart, so similar."

While there are some variations between the forms of assumption reinsurance and indemnity reinsurance, those differences have no bearing on the economic substance or purpose of their common element—the payment of a ceding commission—and they do not justify different tax treatment. We fully recognize that assumption reinsurers take on direct liability to the policyholders (while indemnity reinsurers do not), that assumption reinsurers will typi-

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ferent result when, *unlike the agreements in question here*, the reinsurer did not expressly agree to pay any such "ceding commission," but simply agreed to accept, as consideration for assuming liabilities on the reinsured policies, an amount that was less than the required reserves. See and compare Section 1.817-4(d), Examples (1) and (3), of the Treasury Regulations on Income Tax, with *Mutual Savings Life Ins. Co.* v. *United States*, 488 F.2d at 1145-1146 (the Georgia life transaction) and *Security Benefit Life Ins. Co.* v. *United States*, 726 F.2d 1491 (10th Cir. 1984). We believe the latter cases were erroneously decided, but they are plainly distinguishable from this case (and, in any event, both relied on an example given in an earlier version of Section 1.817-4(d) of the Regulations that has since been changed). See *Oxford Life Ins. Co.* v. *United States*, 790 F.2d at 1374-1375.

cally assume 100 percent of the liabilities on the policies (while indemnity reinsurers may reinsure all or part of the liability), and that assumption reinsurers take permanent possession of the reinsured business (while indemnity reinsurers may allow the initial insurer to recapture the reinsured business). See *McGill, supra* at 435-440. These differences, however, do not alter the essential characteristics of ceding commissions. It is entirely immaterial which company is "directly" liable to policyholders;[13] the issue here concerns only the taxation of the price of shifting the income stream under the block of reinsured policies from the ceding company to the reinsurer.[14] Moreover, assump-

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[13] Indeed, the fact that the indemnity reinsurer is not "directly" liable to the policy holder is irrelevant, as a practical matter, to its ultimate liability to cover the benefits payable under the reinsured policies. Indemnity reinsurance agreements generally provide (and indeed, are often required by law to provide) that the insolvency of the ceding company will not release the reinsurer from its obligation to pay unsatisfied claimants its share of the benefits payable. See McGill, *supra*, at 444. A provision generally to this effect was set forth in the agreements at issue here. Thus, just as in assumption reinsurance, the indemnity reinsurer stands essentially in the shoes of the initial insurer from the vantage point of both its financial rewards and its financial obligations.

[14] It could not be contended, for example, that, if an assumption reinsurer simultaneously entered into a management agreement with the initial insurer for the latter to continue to collect premiums, pay benefits, and so forth (for a fee), the assumption reinsurer would be any less the "owner" of the income-producing interests under the policies. By the same token, the indemnity reinsurer is no less the "owner" of an intangible interest in future income simply because it does not pay benefits to, or receive premiums directly from, policyholders.

tion reinsurance cannot be distinguished from indemnity reinsurance on the ground that an entire block of policies is shifted to the reinsurer, rather than only some percentage of it. The percentage of policies reinsured in an indemnity agreement can easily represent the bulk of the interest in the policies, as it did in this case. But even a lesser percentage of reinsurance would provide the reinsurer with a share in a future income stream, for which the reinsurer pays an acquisition cost in the form of a ceding commission. Finally, the duration of an indemnity reinsurance transaction may be shorter than that of an assumption transaction, but the length of the agreement bears only on the appropriate amortization period, not on whether the acquisition cost is capital in nature. The fact that the indemnity insurer acquires only a portion of future income rights (rather than all of the rights) cannot spare it from capitalizing its acquisition costs, any more than the purchaser of a life estate in property can avoid capitalizing its acquisition costs because it did not purchase the fee simple.[15]

[15] Petitioner relies (Br. 11, 15 n.19, 23 n.30, 26 n.35) on *Oxford Life Ins. Co.* v. *United States, supra*, 790 F.2d 1370, 1376 (9th Cir. 1988), in which the court suggested in passing that assumption reinsurers and indemnity reinsurers may be accorded different tax treatment with respect to ceding commissions. But the proper treatment of indemnity reinsurance was not at issue in that case, since the taxpayer in *Oxford* had undertaken only an assumption reinsurance transaction. Moreover, in a more recent decision involving the same taxpayer, this time concerning an indemnity reinsurance transaction, a district court in the Ninth Circuit declined to rely on the dicta cited above, but instead adopted the reasoning and holding of the Eighth Circuit's decision in *Prairie States. Oxford Life Ins. Co.* v. *United States*, No. CIV 84-959 PHX RGS (D. Ariz. Oct. 15, 1987), appeal pending (9th Cir. No. 88-2955). The district court thus held that ceding commissions in *indemnity* transactions must be capitalized and amortized, just as ceding commissions in *assumption* transactions must be capitalized and amortized.

Petitioner argues (Br. 16) that because Congress in 1959 wrote several provisions into the Code that apply exclusively to assumption reinsurance (Sections 806(a) and 809(d)(7), for example), it follows that assumption and indemnity reinsurance should also be accorded different treatment here. But those provisions respond to specific issues relating to the differences in the forms of the transactions that we identified above (and that are irrelevant to the tax treatment of ceding commissions). None of those provisions suggest that the 1959 Congress viewed assumption reinsurance purely as a "sale of assets" and indemnity reinsurance purely as the issuance of new "insurance," thus justifying vastly different tax treatment of the essentially similar ceding commissions.[16] In fact, both kinds of

[16] Petitioner merely cites (Br. 14-16) Sections 809(d)(7) and 806(a) without explaining how those provisions fit its theory about ceding commissions. Those sections are completely unrelated to payments of such commissions. Section 809(d)(7) allows a deduction for amounts paid by a *reinsured company* under an assumption reinsurance agreement. That provision illustrates only that Congress intended to maintain *tax parity* between indemnity and assumption reinsurance. In indemnity reinsurance the initial insurer continues to receive premiums that are includible in its own income under Section 809(c)(1), but can then use that provision to subtract from its income premiums paid to reinsurers. In assumption reinsurance the initial insurer ceases to receive premiums included in income under Section 809(c)(1), and therefore cannot subtract its payments to the reinsurer from *its* gross premium income under that section, even though a deduction is obviously appropriate. Section 809(d)(7) thus fills a gap by allowing initial insurers in assumption reinsurance a deduction already available in indemnity transactions under Section 809(c)(1).

Similarly, petitioner points (Br. 16) to Section 806(a) of the Code (which provides for allocation of reserves in assumption reinsurance and specifies that it does not apply to indemnity reinsurance). That Section reflects Congress's recognition that assumption reinsurance and indemnity reinsurance generally differ in their duration. In assumption reinsurance, the reinsurer assumes the reserves for the life

transactions partake of elements of a sale and of an insurance transaction; the ceding commission aspect of both, however, requires amortization tax treatment, regardless of how the transaction is characterized.

Petitioner errs in contending that the legislative history establishes that Congress "intend[ed] to treat indemnity reinsurance and assumption reinsurance differently for tax purposes" (Pet. Br. 17, 23 n.32). Read in context, the legislative history says nothing that supports the deductibility of ceding commissions. As petitioner notes, the Senate Committee report stated in passing that, "as distinct from assumption reinsurance, the initial risk in [indemnity reinsurance] remains with the insurer but he covers this risk by reinsuring part or all of a contract with another insurance company." S. Rep. No. 291, *supra,* at 38. But, contrary to petitioner's suggestion (Br. 17), the Committee's purpose was not to discuss the tax treatment of assumption reinsurance as compared to indemnity reinsurance, or to deal with ceding commissions in either type of transaction. Rather, that language introduced the Committee's analysis of modified coinsurance transactions only with respect to one item: the potential double taxation of investment income paid to the reinsurer with respect to the reserves retained by the initial insurer.[17] The only reasonable conclusion to be drawn from this discussion is

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of the policies, while in indemnity reinsurance, the reinsurer assumes liability for the reserves for a period of time that may be less than the life of the policies. This difference accounts for the two types of reinsurance being treated differently with respect to reserve allocation. But petitioner never explains how the different treatment of assumption and indemnity reinsurance under Section 806(a) has anything to do with ceding commissions.

[17] After analyzing the problem in this area, the Committee proposed a solution, which was embodied in Section 820. S. Rep. 291, *supra*, at 39.

that Congress paid careful attention to the details of life insurance company taxation and adverted to the problems it sought to solve. Yet nowhere in the legislative history did Congress ever articulate a desire to relieve indemnity reinsurers from the capitalization rules otherwise applicable to taxpayers who make current expenditures for future economic benefits.

It is true that capitalization of ceding commissions paid by assumption reinsurers is specifically required by Treas. Reg. § 1.817-4(d)(2)(ii)(B), while there is no analogous regulation addressing the treatment of ceding commissions paid in indemnity transactions. But, while this regulation does not by its terms apply to indemnity reinsurers, the principles underlying it most certainly do. It would read far too much into the absence of a parallel regulation with respect to indemnity reinsurance to find, as petitioners contend (Br. 18-20), that the IRS intended indemnity reinsurers to take a current deduction of their ceding commissions.[18] As the Eighth Circuit recognized, "the inap-

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[18] Treas. Reg. 1-817-4(d)(2)(ii) was promulgated in the wake of a transitional rule for assumption reinsurance transactions (Section 817(e)) that lapsed beginning in 1959. The transitional rule related to capital gains or losses in assumption transactions in 1958, and provided that the policies sold in such an assumption transaction would be treated as the sale of a capital asset. This rule meant that the *initial insurer*'s gains from 1958 transactions would not be taxed, because life insurance companies' capital gains were not taxable until 1959. S. Rep. No. 291, *supra,* at 29-30. "Following the expiration of that transitional rule, the Code left open the tax treatment of such transactions, and the regulation is intended to govern transactions after December 31, 1957." *Prairie States,* 828 F.2d at 1230 n.7 (citation omitted). See also *Beneficial Life Ins. Co.* v. *Commissioner,* 79 T.C. at 645 n.22. The regulations provide that after 1958, the initial insurer in an assumption transaction cannot receive favorable capital gains treatment for the transfer of policies. The regulations go on to clarify, however, that the assumption reinsurers' interest in the policies ac-

plicability of the regulation to taxpayer's indemnity transaction does not mean that the transaction is not governed, under the applicable statutory provisions, by principles similar to those illustrated in the regulation." *Prairie States*, 828 F.2d at 1232.[19] "Rather," the court explained, "the regulation is silent as to their treatment" (*ibid.*), and the gap must be filled by application of fundamental tax principles.[20]

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quired is still capital in nature (thus requiring the ceding commission to be amortized). The particular need for the IRS to clarify the capital gains issue for *initial insurers* in assumption transactions may explain why it promulgated a regulation for assumption transactions, but not indemnity transactions. Contrary to petitioner's suggestion (Br. 19 n.26), however, nothing in this history has the slightest significance for determining how to treat the ceding commissions paid by the *reinsuring company* in this case.

[19] The Tax Court in *Beneficial Life*, 79 T.C. 627, 645, and in this case, Pet. App. 17a, apparently felt compelled to draw a negative implication from the assumption regulation, even though it recognized that its holding led to a "strange" result (*id.* at 19a). But the regulation on its face does not prescribe anything about indemnity reinsurers, and it need not be read to imply anything on that subject. Surely, the IRS, when it needs to deal with a particular type of transaction by regulation, is not required to deal at the same time with all other transactions that might be comparable to the one being specifically addressed, in order to avoid the risk that implications for similar transactions will be read into the regulation.

[20] Petitioner also erroneously suggests (Br. 13 n.14) that the IRS formerly took the view that ceding commissions in indemnity transactions are deductible in the year of payment, citing Rev. Rul. 70-552, 1970-2 C.B. 141, 142. In that ruling, the IRS was asked to consider the tax treatment, not of the kind of up-front ceding commissions involved here, but of a very different kind of payment, albeit one referred to as a "ceding commission." The ceding commissions there (on casualty reinsurance) were paid *annually* to cover expenses incurred by the initial insurer. Thus, the situation addressed in the ruling did not present a capitalization issue, and it bears no relevance whatever to the question here of an "up-front" ceding commission paid to obtain in-

Petitioner argues at length (Br. 2, 10-13, 15, 21, 24-25) that indemnity reinsurance is just a form of "insurance." Despite petitioner's insistence on this characterization, at bottom it makes no difference to the tax treatment of *ceding commissions* whether indemnity insurance is called "insurance" for one purpose or another, for the name used cannot alter the underlying, long-term financial benefits for which the reinsurer pays a ceding commission. As an industry representative explained to the Senate Finance Committee in its 1959 hearings, "[t]he original insurer, desiring indemnity, is content to share its policies' earning potentials; the reinsure[r], willing to accept a risk under a collateral indemnity contract, can rightfully name its price in terms of a share in the earnings and profits of the contractual adventure." Hearings on H.R. 4245, 86th Cong., 1st. Sess. 607 (1959) (statement of Henry F. Rood). Quite simply, "reinsurance has the effect of dividing a single source of income into segments" (*id.* at 610).[21] The segment of future income acquired by the indemnity reinsurer is paid for by the negotiated ceding commission. There is no reason to treat the expenditure as other than an intrinsically capital outlay.

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come in future periods. When the IRS did address that issue for the first time in a Revenue Ruling, it distinguished its earlier handling of the annual ceding commissions and concluded that "the 'up-front ceding commission' is paid with respect to the acquisition of an agreement or contract with a readily determinable useful life." Rev. Rul. 82-69, 1982-1 C.B. 102, 103. Accordingly, it ruled that such a ceding commission "must be amortized over the term of the agreement." *Ibid.*

[21] The statement was made to urge Congress to recognize the risk of double taxation in the modified coinsurance context. See *Consumer Life*, 430 U.S. at 747. There is no mention of ceding commissions – and certainly no suggestion that they should be deductible – in that statement.

II. NO PROVISION OF THE CODE OVERRIDES THE GENERAL CAPITALIZATION PRINCIPLE TO PERMIT THE CURRENT DEDUCTION OF CEDING COMMISSIONS

The capitalization rules that generally apply to payments for future benefits, such as the ceding commission here, are controlling unless Congress specifically withdrew the application of those rules from taxpayers in petitioner's situation. Such an exception would depart from the tax principles generally applicable to all other taxpayers, and an intent to create that sort of disparity should not lightly be imputed to Congress. Although petitioner relies on three sections of the Code to support the deduction of ceding commissions in the year paid, none of those provisions provides the dispensation from the basic rules of capitalization that petitioner seeks.

A. The Ceding Commissions Payable to Transport Under the Coinsurance Agreements Cannot Be Used to Reduce Gross Premiums Under Section 809(c)(1) of the Code

Section 809(c)(1) requires that life insurance companies compute their actual premiums as a preliminary step in determining taxable "gain from operations." The first sentence of that Section requires life insurance companies to include in income "[t]he gross amount of premiums and other consideration (including * * * consideration in respect of assuming liabilities under contracts not issued by the taxpayer) * * * less return premiums, and premiums and other consideration arising out of reinsurance ceded." The second sentence excludes certain types of payments from "return premiums." It states, "[e]xcept in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance

ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of management shall not be included in return premiums."

Petitioner erroneously contends (Br. 22-23) that Section 809(c)(1) and Treas. Reg. §_1.809-4(a)(1)(ii) mandate the inclusion of "ceding commissions" in "return premiums," with the necessary effect of reducing gross premium income in the year that ceding commissions are paid. This contention ascribes to Congress and the IRS an affirmative intent to require reinsurers to reduce their current income by the amount of payments made to acquire future benefits. There is no plausible basis for that conclusion. Rather, the manifest purpose of Section 809(c)(1) is far narrower in scope. Read in context, Section 809(c)(1) permits the deduction only of "illusory" premium income that, with the benefit of hindsight, would never have been included in premium income in the first place. For example, amounts returned to a policyholder (under a provision fixed in the policy), amounts refunded by a reinsurer to the initial insurer pursuant to experience-based formulas or for similar reasons, or amounts paid by an initial insurer to obtain reinsurance are all payments that are legitimately subtracted from gross premium income under Section 809(c)(1). But that Section was never intended to provide a deduction for large, up-front payments that entitle reinsurers to a share of future profits from a block of policies.

Section 809(c)(1), on its face, is focused on the determination of premium *income*. Thus, it first provides for taking the "gross amount of premiums and other consideration" into account and then for elimination from such "gross premiums" two items, *viz.* "return premiums"

and "premiums and other consideration arising out of reinsurance ceded." As expressed by the Eighth Circuit, both types of adjustments were intended "to eliminate from the 'gross amount of premiums and other consideration' those portions of premiums received which do not, in the end, 'belong' to the company in question, but which must be returned to the policy holder or turned over to or shared with another company under an indemnity reinsurance contract." *Modern American Life Insurance Co.* v. *Commissioner*, 830 F.2d at 114; *Prairie States Life Ins. Co.* v. *United States*, *supra*, 828 F.2d at 1233. Ceding commissions in no way constitute "portions of premiums received which do not, in the end, 'belong' to the company in question" (*Modern American*, 830 F.2d at 114); rather, they represent consideration paid at the outset of a reinsurance transaction to acquire a profitable stream of premium income.

To begin with, ceding commissions are not "return premiums." Petitioner argues (Br. 22-23) that Treas. Reg. 1.809-4(a)(1)(ii) brings ceding commissions within the ambit of return premiums, but that regulation provides no assistance to petitioner. The regulation defines "return premiums" to include "amounts of premiums or other consideration *returned* to another life insurance company in respect of reinsurance ceded." *Ibid.* (emphasis added). The ceding commissions in this case are not "consideration returned" to the initial insurer. The true nature of a ceding commission is a payment made contemporaneously with the closing of the transaction in order to acquire valuable future rights to premium income. The up-front ceding commissions are not being "returned" to the initial insurer, and there is no reason to strain the language of the regulation to include them.

The legislative materials confirm that the words "return premiums" were never meant to cover ceding commissions in indemnity reinsurance transactions. The legislative history identifies only one situation in which an indemnity reinsurer can rely on Section 809(c)(1) to reduce its premium income by sums paid to the initial insurer—and that situation is *not* the payment of ceding commissions. The Senate Finance Committee observed that if the indemnity reinsurer must pay a portion of premiums "ceded" back to the initial insurer pursuant to an experience rated refund clause, the reinsurer can reduce its gross premium income by that amount. See S. Rep. No. 291, *supra*, at 39 ("the experience refunds paid by the reinsurer to the initial insurer are treated as reductions in premium income of the reinsurer"). [22] "Experience refunds," however, are nothing like the ceding commissions here. Experience refunds simply readjust the amounts of premiums paid to the reinsurer to reflect the fact that fewer benefits had to be paid on the reinsured risks than had been projected, or that other unanticipated savings materialized. McGill, *supra*, at 445. That type of payment is properly viewed as a "return" to the initial insurer of a portion of the premiums the reinsurer previously received.[23] But it cannot seriously be

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[22] The original House proposal was somewhat unclear on the deductibility of such payments by the reinsurer, but amendments made by the Senate (including the addition of the first clause of the second sentence of Section 809(c)(1)) served to clarify that they would be deductible by the reinsurer under Section 809(c)(1), even though similar refunds made to policyholders by the original insurer might be treated only as dividends (which are deductible under Section 809(d)(3) only within certain specified limits). See S. Rep. No. 291, *supra*, at 39; *Prairie States*, 828 F.2d at 1226-1227.

[23] On the same basis, a reinsurer could reduce its gross premium income under Section 809(c)(1) if a portion of the premiums it received from the ceding company must be returned, for example, to cover the

contended that a "ceding commission," paid to obtain the future profits to be generated by the reinsured policies, is like an "experience refund," or any other permissible adjustment to premium income under Section 809(c)(1)'s provision for return premiums.[24]

Likewise, there is no basis for subtracting ceding commissions from income under the branch of Section 809(c)(1) allowing a deduction for "premiums and other consideration arising out of reinsurance ceded." Indeed, petitioner does not even contend that that language is applicable to the ceding commissions here (see Br. 22-24). It

latter's "return premiums" to policy holders. Again, that would be an adjustment that is necessary to reflect accurately the true premium income of the reinsurer. In addition, modified coinsurance agreements typically provide for the payment back to the reinsurer of a specified portion of the premiums received at the outset, and for the subsequent return of amounts necessary to cover specified expenses and additions to reserves. See, McGill, *supra* at 438-440. Those payments might also be regarded as the type that would appropriately be considered "return premiums" subtracted from income under Section 809(c)(1).

[24] Similarly, there is no basis for treating the payment of a "finder's fee" as an adjustment to gross premiums, as petitioner advocates (Br. 7 n. 5). As we have noted (note 7, *supra*), the Tax Court was in error in asserting that the Commissioner had conceded that if the ceding commissions were deductible under Section 809(c)(1), then the finder's fee would also be deductible on the same basis. Indeed, there is not even a colorable basis under Section 809(c)(1) for allowing such a deduction. It is well settled that such finder's fees in connection with the acquisition of assets must be capitalized as part of the cost basis of such assets. See, 1 B. Bittker, *supra*, ¶ 20.4.2, at 20-59; 2 *id.* ¶41.2-3, at 41-12. The finder's fee, of course, represents an insignificant portion of the deduction claimed by petitioner. Our principal point is that there is no more reason to allow an immediate deduction for the amounts paid directly to acquire the future benefits provided by these agreements (the ceding commission) than there is to allow such a deduction for amounts paid to a third party for bringing this opportunity to petitioner's attention (the finder's fee).

is evident that Section 809(c)(1)'s allowance for "premiums and other consideration arising out of reinsurance ceded" permits only the *ceding company* to reduce its premium income by amounts paid to a reinsurer arising out of indemnity reinsurance agreements. Properly construed, that deduction is simply the indemnity insurance analogue to Section 809(d)(7), which permits the ceding company in assumption reinsurance to deduct consideration paid to the reinsurer (see note 16, *supra*).[25]

The structure of the Code confirms that Section 809(c)(1) has a limited focus that in no way was designed to alter the usual rules of capitalization. Section 809(c)(1) is one of three items grouped under the heading "Gross Amounts," each of which is designed to capture sources of income. In contrast, the "Deductions" from income are in a separate subsection, Section 809(d). There, Congress provided for twelve deductions specially tailored for life insurance companies. If it had intended to do so, subsection (d) was the obvious place for Congress to have provided for the deduction of such a major item as a reinsurance ceding commission.

Nor does the somewhat sparse legislative history of Section 809(c)(1) justify construing it as a significant depart-

[25] Section 809(d)(7) provides for the deduction of "consideration (*other than consideration arising out of reinsurance ceded*) in respect of the assumption by another person of liabilities under insurance or annuity contracts • • •." *Id.* (emphasis added). The use of the identical language—"consideration arising out of reinsurance ceded"—in the two neighboring Sections (809(c)(1) and (d)(7)) suggests that Congress intended the same meaning to control in each. Since the words "consideration arising out of reinsurance ceded" in Section 809(d)(7) refer only to payments by the reinsured company (see S. Rep. 291, *supra*, at 55; H.R. Rep. No. 34, 86th Cong., 1st Sess. 30 (1959)), the same construction is appropriate for the identical language in Section 809(c)(1), which thus cannot cover ceding commissions paid by the reinsurer.

ture from settled capitalization rules that do not permit the deduction of ceding commissions paid in indemnity reinsurance transactions. Although petitioner struggles to find support in the legislative history (Br. 10, 11, 14 n.17, 17-18, 23 n.32, 26), there is simply no indication that Congress actually intended Section 809(c)(1) to allow premium income to be adjusted by subtracting ceding commissions. The Committee reports make no reference to ceding commissions in the explanations of the proposed language that became Section 809(c)(1), or elsewhere.[26] Given the exten-

[26] Relevant portions of the Committee reports contain no reference to ceding commissions, although they cover numerous other (dissimilar) types of adjustments. For example, the Senate Committee's technical analysis explained Section 809(c)(1) this way:

> Subsection (c) specifies three categories of receipt items which are taken into account in determining whether there is a gain or loss from operations under Section 809. Under paragraph [1] the gross amount of all premiums and other consideration on insurance and annuity contracts (including supplementary contracts) is taken into account; less return premiums, and premiums and other consideration arising out of reinsurance ceded. The premiums and other consideration taken into account include advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer. In excluding return premiums, amounts returned (by whatever name called) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management are not to be treated as return premiums, except in the case of return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract. Furthermore, amounts rebated or rendered due to policy cancellations or to erroneously computed premiums are to be treated as return premiums.

S. Rep. No. 291, *supra*, at 54; see also *id.* at 21. The House Committee report contains a similar discussion. H.R. Rep. No. 34, *supra*, at 29-30. The floor debate on the bill did not touch on issues relating to "reinsurance ceded."

sive consideration by Congress of the intricacies of life insurance taxation, it is not plausible to believe that the extraordinary income tax benefit petitioner now seeks, which is incompatible with tax treatment for other taxpayers who incur present outlays for future benefits, somehow "slipped through" the process without any legislative consideration at all.

Indeed, that point is confirmed by the attention to detail evidenced in the legislative history. The Senate Committee report took the trouble to note that an adjustment was appropriate for "amounts rebated * * * due to policy cancellations or to erroneously computed premiums." S. Rep. No. 291, *supra*, at 54. Likewise, as we have noted, the report mentions that reinsurers could subtract from their gross premiums "experience refunds" paid to the ceding company. See *id.* at 39. The same Congress that expressly tinkered with the details of "gross premiums" by carving out "erroneously computed premiums" and "experience refunds" as items of adjustment cannot reasonably be thought to have altered basic taxation rules for capitalizing acquisition costs, without any comment at all. Cf. *Church of Scientology* v. *IRS*, 108 S. Ct. 271, 276 (1987). Indeed, it would be highly incongruous for Congress to remark on the relatively minor payment item of "experience refunds," but totally ignore the much more economically significant "ceding commissions." The only rational explanation is that Congress framed Section 809(c)(1) to measure "premium income" fairly—in light of the practice of insurers to relinquish or return some premiums to others and therefore not enjoy their benefit—but did not intend to create a new type of deduction for the capital expense of a ceding commission.[27]

[27] Petitioner relies heavily (Br. 17-18, 25 n.33) on the comments of the staff of the Joint Committee on Taxation, twenty-five years after

B. The Ceding Commissions Are Not "Ordinary and Necessary" Expenses Deductible Under Section 809(d)(12) of the Code

Petitioner makes the alternative argument (Br. 24-26) that ceding commissions are ordinary and necessary expenses of its reinsurance business, and are therefore deductible in the year incurred under Section 809(d)(12).[28] Petitioner reasons that just as commissions paid to agents who sell policies to the public are deductible in the year

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the fact. Those comments could not conceivably shed any light on the intent of the 86th Congress that wrote Section 809(c)(1), cf. *Weinberger* v. *Rossi*, 456 U.S. 25, 35 (1981) ("*post hoc* statements of a Congressional Committee are not entitled to much weight"), but, in any event, they do not aid petitioner on their merits. The staff report remarked, in passing, that assumption reinsurance is treated as the "sale of a block of business," while indemnity reinsurance "describes a continuing insurance relationship between the ceding company and the reinsurer." Report of the Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 1st. Sess 633 (Joint Comm. Print 1984). The staff never spoke to the tax treatment of ceding commissions, and its comments may very well have been prompted by a reading of the Code provisions regarding the two types of reinsurance that we have noted—and distinguished from the present issue (note 16, *supra*). Similarly, Technical Advice Memorandum (TAM) 8742004, IRS Letter Rul. Rep. (CCH) (June 30, 1987) (see Pet. Br. 18), which in any event may not be cited as precedent (I.R.C. § 6110(j)(3)), in no way suggests that the costs of acquiring indemnity reinsurance policies are any less subject to capitalization than the costs of acquiring assumption reinsurance policies.

[28] Section 809(d)(12) "implicitly incorporat[es] I.R.C. § 162(a), which provides a deduction for 'ordinary and necessary expenses' in conducting a business." *Prairie States*, 828 F.2d at 1233. (Section 809(d)(12) was renumbered Section 809(d)(11) by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(98)(B)(i), 90 Stat. 1520.)

incurred, so should ceding commissions paid by reinsurers to the reinsured company be deductible. But the argument rests on a false analogy. The ceding commissions a reinsurer pays the ceding company are not remotely similar to the commissions that an insurance company pays to its agents for personal services rendered in writing new policies. Indeed, virtually the only point of similarity is that both sorts of payments are commonly referred to as "commissions."

First, in the case of a single policy, the insurer does not pay the *policyholder* for agreeing to purchase life insurance. That, however, is exactly what happens with a ceding commission. A reinsurer pays a ceding commission, not to compensate its agent for selling a policy, but to induce the initial insurer to transfer to it—via a reinsurance transaction—a valuable future income stream in a block of policies. A payment to another party to induce it to assign contract rights expected to produce future profits would not typically be regarded as an "ordinary and necessary" business expense. It certainly cannot be equated with standard agent's commissions that are basically a form of salary expenses. See *Southwestern Life Ins. Co.* v. *United States*, 560 F.2d at 641. The ceding commission paid for the reinsurer's share is thus no more akin to ordinary agent's commissions than is the similar ceding commission paid to acquire policies in an assumption transaction.

The fact that Congress intended to allow a current deduction for the routine expenses incurred by a company in connection with the writing of new insurance policies is made clear in the legislative history of the 1959 Act. See S. Rep. No. 291, *supra*, at 7, 9; H.R. Rep. No. 34, 86th Cong., 1st. Sess. 4 (1959). But a ceding commission bears

none of the "ordinary and necessary" attributes of agent's commissions and the other expenses of writing new policies (medical examinations, administrative overhead, etc.) that are currently deductible. And there is no indication at all in the legislative history that Congress viewed ceding commissions as analogous to those routine expenses or as deserving of similar tax treatment.

In short, petitioner simply has not incurred "a sales expense" in paying a ceding commission to place new business on its books, and thus the ceding commissions are not deductible as such under Code Sections 162 and 809(d)(12). Rather, as in the case of assumption reinsurance, ceding commissions in indemnity transactions simply reflect the current value to the reinsurer of the rights acquired with respect to the reinsured policies themselves. See *Modern American Life Ins. Co.* v. *Commissioner, supra; Prairie States Life Ins. Co., supra.*

C. The NAIC Methods of Accounting for Ceding Commissions Are Not Controlling Under Section 818 of the Code Because They Are Inconsistent with the Accrual Method of Accounting, Which Takes Precedence over the NAIC-Approved Method of Computation.

Petitioner argues (Br. 5-6, 26-30) that because ceding commissions are currently deductible for purposes of the National Association of Insurance Commissioners (NAIC) annual statement, it follows that the ceding commissions must be currently deductible for income tax purposes as well. That argument is unpersuasive. Section 818(a) requires life insurance companies to make "computations entering into the determination of taxes imposed by this part * * * in a manner consistent with" the annual statement approved by the NAIC, *except* when that would be inconsistent with accrual accounting rules. 26 U.S.C. 818(a); *Standard Life*, 433 U.S. at 158-159. Thus, when

the "rules of accrual accounting dictate a contrary result," *id.* at 159, the NAIC procedures must yield. That is the case here with respect to ceding commissions.

Accrual accounting requires the acquisition costs of a future benefit to be capitalized, rather than written off in the year paid. Section 1.461-1(a)(2) of the Treasury Regulations on Income Tax embodies that rule as follows (emphasis added):

> *Taxpayer using an accrual method.*—Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. ***However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred.***

See also 4 B. Bittker, *supra*, at 105-69. That regulation forbids the complete deduction, under an accrual accounting method, of outlays that serve to create identifiable economic benefits extending over more than one year. In mandating that an accrual method of accounting take precedence over NAIC computational procedures when they are inconsistent with each other, Congress made this capitalization principle controlling for life insurance companies, just as it is for all other accrual method taxpayers.[29]

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[29] The Tax Court (which ruled in petitioner's favor on the question presented here) has never suggested that Section 818(a) had any bearing whatsoever on the resolution of this question. And, of course, neither the Fifth Circuit here nor the Eighth Circuit in *Prairie States* and *Modern American* accepted such an argument. The only court to express a contrary view is the Seventh Circuit in *Merit Life*, and we

It is not surprising that accrual accounting should diverge from NAIC procedures. The two approaches have strikingly different purposes and different intended audiences. As one court of appeals explained, "there 'are several areas where differences exist between the accrual basis used for the annual statement and the general rules of accrual for tax purposes' because 'the emphasis of the annual statement has been on the solvency of the company.' " *Jefferson Standard Life Insurance Co.* v. *United States,* 408 F.2d 842, 849-850 (4th Cir. 1969) (quoting R. Denney and A. Rua, *Federal Income Taxation of Insurance Companies* at 9.3 (1961)), cert. denied, 396 U.S. 828 (1969); see also *Liberty Life Insurance Co.* v. *United States,* 594 F.2d 21, 25 (4th Cir. 1979). The approach to writing off expenditures, such as the ceding commissions here, presents a good example of the differences between annual statement and tax accounting. It is consistent with a conservative approach to measuring an insurance company's resources—in line with preserving an institution's solvency—to write down income immediately by the amount paid by an indemnity reinsurer to acquire future income from a block of policies. But that same accounting philosophy skews the proper measurement of taxable in-

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submit that that court erred from the outset when it accepted the Tax Court's premise that indemnity reinsurance is comparable to direct insurance. Indeed, petitioner's argument that NAIC accounting procedures are controlling ultimately proves too much, for the NAIC procedures on which it relies appear equally to require a first-year write off, not only of ceding commissions paid in indemnity reinsurance, but also of those paid in assumption reinsurance as well (contrary to accrual accounting principles, Treas. Reg. § 1.817-4(d)(2)(ii)(B), and the settled authority (see note 12, *supra*)). See G.K. Patterson, *Reinsurance,* at 539 (R. Strain 1980); C.M. Beardsley, *Life Company Annual Statement Handbook,* at 4-1 (1974); *Oxford Life Ins. Co.* v. *United States,* 574 F. Supp. 1417, 1421 (D. Ariz. 1983), aff'd, 790 F.2d 1370 (9th Cir. 1986).

come by creating an imaginary present day loss from a transaction fully expected to produce future gains. Compare *United States* v. *General Dynamics Corp.,* 481 U.S. 239, 246 (1987) (financial accounting); *Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522, 538-544 (1979) (same). Thus, Congress understandably protected federal revenue by prohibiting the use of the NAIC methodology when it transgresses standard accrual accounting rules.

Indeed, industry accounting guides, other than the NAIC, recognize that indemnity reinsurers are buying a future stream of income from a block of policies, which requires the ceding commission to be capitalized and amortized. *The Industry Audit Guide of Stock Life Insurance Companies* (1972), prepared by the Committee on Insurance Accounting and Auditing of the American Institute of Certified Public Accountants, has recognized (at 92) that a ceding commission is in the nature of an "acquisition expense" for the purchase of business. Thus, the guide states:

> Under generally accepted accounting principles for special reinsurance agreements which are constructed so as the shift a significant part of the economic risk from one company to another * * * [t]he net cost to the assuming company should be treated as an acquisition expense to be amortized over the premium-paying period on a basis consistent with that used for acquisition expenses of other business.

Ibid. The generally accepted accounting principles reflected in the guide provide a clear indication that accrual accounting methods do not permit the current deduction of ceding commissions, even for ordinary financial statement purposes. Thus, petitioner's contention that this Court must recognize a current deduction for ceding

commissions to "give effect to the NAIC accounting" requirements (Br. 30) has no application to this context.

* * *

This case clearly illustrates the abuses that petitioner's position would invite in the taxation of reinsurance transactions. As petitioner's expert witness acknowledged, profitable insurance companies could utilize such reinsurance agreements each year to defer taxation indefinitely on *all* of their underwriting gains (Tr. 58). Indeed, the combination of coinsurance and modified coinsurance agreements used here to create "wash" transactions with little cash changing hands would enable petitioner to manufacture such "tax losses" without incurring any substantial net out-of-pocket cash outlays at all. Thus, the only limitations on a life insurance company's ability to offset all of its underwriting gains in this manner would be the amount of its surplus and the willingness of potential ceding companies to share their policies' future profits at a commensurate present-day price. In short, the *more* such potentially profitable transactions an indemnity reinsurer enters, the *less* its tax liability would become. Nothing in the Code authorizes what would amount to a reinsurance shell game, in which the premium income from indemnity reinsurance would continually be advanced from year to year, but never be recognized for purposes of federal income taxation.

Amici American Council of Life Insurance, et al. suggest (Br. 23-26) that denying an indemnity reinsurer the benefit of an immediate write-off of ceding commissions will "disadvantage" direct writers that depend on reinsurance to grow. That argument stands the issue in this case on its head. Treating indemnity reinsurers consistently with all other taxpayers who incur present outlays for

future benefits cannot fairly be characterized as penalizing the reinsurance industry or its clients. As in the case of assumption reinsurance, the effect of requiring the reinsurer to capitalize and amortize these ceding commissions over the projected life of the reinsurance agreement is simply to match the annual revenues generated under the agreement against the cost of acquiring the right to such revenues. It is not punitive to deny the reinsurer the benefit of the huge initial "tax losses" claimed in such cases where, in fact, the reinsurer fully expects to enjoy a long-term profit on the transactions, and, indeed, may not even be required to disburse any substantial funds of its own in acquiring such rights.[30]

In sum, the court of appeals was correct in recognizing that ceding commissions in indemnity reinsurance are inherently capital outlays, and that neither Section 809(c)(1)

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[30] Amici predict dire consequences for the industry and consumers if this Court were to rule for the IRS (Br. 25). Amici raise the specter that reinsurers would not be willing to pay such large ceding commissions as they do now to enter indemnity reinsurance agreements unless they can enjoy similarly large tax benefits, and that smaller or newer insurance companies, which have a greater need for reinsurance, would thus have to charge the public higher premiums to make up for this lost income. In the first place, that speculative argument rests on a shaky empirical premise, since even smaller and newer companies operate in a competitive environment and cannot simply raise their premiums at will. At bottom, however, amici's policy argument only recognizes that the direct impact of this case falls on the *re*insurance industry, and that the consequences for other parties are simply guesswork. Indeed, it seems far more likely that the only significant impact of a decision affirming the judgment below (other than on tax revenues) would be to discourage reinsurance transactions when the dominant purpose is simply tax avoidance, rather than an independent business reason. In any event, amici's contentions concerning desirable policy should be presented to Congress, rather than to this Court.

nor any other provision of the Code allows them to be currently deducted. Under well established tax principles, the amount paid to acquire the right to future income from reinsured policies in indemnity reinsurance must be capitalized and amortized over the period of indemnification.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

The Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the years 1975 and 1976, provided in relevant part:

§ 809 **In General.** –

* * * * *

(c) **Gross Amount.** – For purposes of subsections (b)(1) and (2), the following items shall be taken into account:

(1) **Premiums.** – The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

* * * * *

(d) **Deductions.** – For purposes of subsections (b)(1) and (2). There shall be allowed the following deductions:

(7) **Assumption by another person of liabilities under insurance, etc., contracts.** – The consideration (other than consideration arising out of reinsurance ceded) in respect of the

assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

* * * * *

(12) **Other deductions.**—Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

* * * * *

§ 818 **Accounting Provisions.**

(a) **Method of Accounting.**—All computations entering into the determination of the taxes imposed by this part shall be made—

(1) under an accrual method of accounting, or

(2) to the extent permitted under regulations prescribed by the Secretary or his delegate, under a combination of an accrual method of accounting with any other method permitted by this chapter (other than the cash receipts and disbursements method).

Except as provided in the preceding sentence, all such computations shall be made in a manner consistent with the manner required for purposes of the annual statement approved by the National Association of Insurance Commissioners.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.809-4 **Gross amount.**

(a)(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see Section 811 (relating to dividends to policyholders).

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No. 88-396

IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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To resolve the issue in this case, the Court must decide whether indemnity reinsurance is treated by the Internal Revenue Code (the "Code") as the issuance of insurance or as the acquisition of an asset. Under the taxing pattern prescribed in Part I of Subchapter L of the Code, life insurance companies typically incur underwriting losses on newly issued insurance in the year such insurance is issued. Such losses occur because the reserves required and expenses incurred in issuing insurance generally exceed

the total premiums received in that year.[1] Although the Commissioner readily acknowledges that issuers of directly-written insurance should deduct in the year incurred the expenses of issuing such insurance, he argues that the taxing pattern prescribed by Part I of Subchapter L does not apply to the type of insurance known as indemnity reinsurance.

The Commissioner's position is premised upon his contention that a life insurance company purchases an intangible asset ("a future stream of income") when it issues indemnity reinsurance and that the ceding commission is incurred to acquire that asset. From this premise, the Commissioner argues that, under so-called "general" or "fundamental" tax principles which apply to "any other taxpayer, in any other setting,"[2] the ceding commission incurred in issuing indemnity reinsurance must be capitalized and amortized.

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[1] Underwriting gains generally will occur after the year in which the insurance is issued only if the premiums charged are in excess of the amounts ultimately required to meet claims and expenses. Because of the long-term nature of insurance, this can be determined only after the insurance is terminated as a result of a claim, surrender, or lapse. *See* S. Rep. No. 291, 86th Cong., 1st Sess. 6-7, *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1581.

[2] Brief for the Respondent ("Comm. Br.") at 7. The "general" principles relied upon by the Commissioner are not as well-settled as he would have this Court believe. *See, e.g.*, 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 20.4 at 20-65 through 20-102 (1981), cited by the Commissioner (Comm. Br. at 16, 32, 39), which describes numerous types of expenditures that taxpayers are authorized to deduct currently although they result in benefits being received beyond the taxable year.

Petitioner, Colonial American Life Insurance Company ("Colonial"), is *not* "any other taxpayer, in any other setting," and indemnity reinsurance is not, and is not taxed as, the acquisition of an asset. During the years in issue, Colonial was a life insurance company issuing insurance in the form of directly-written insurance and indemnity reinsurance and was subject to taxation under the special provisions of Part I of Subchapter L applicable to such transactions.

I.

The Commissioner refuses to acknowledge that Congress treated indemnity reinsurance as the issuance of insurance in Part I of Subchapter L. Instead, he focuses solely on the expectation of an indemnity reinsurer that it will receive future premium income in consideration for the insurance coverage it provides. He then asserts that the issuer of indemnity reinsurance acquires an intangible asset, *i.e.*, "a future income stream," at the time it issues its reinsurance contract.[3]

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[3] According to the Commissioner, since the purchasing company also acquires "a future income stream" in an assumption reinsurance transaction, the ceding commission incurred in issuing indemnity reinsurance should be treated in the same manner as the amount paid to acquire insurance policies in an assumption reinsurance transaction. In fact, the tax treatment prescribed by Treas. Reg. § 1.817-4(d)(2)(ii) for the amount paid to buy insurance policies in an assumption reinsurance transaction is different from the "acquisition of an asset" approach urged by the Commissioner for ceding commissions in indemnity reinsurance transactions. That regulation adopts a "deferred expense" approach for the amount paid in an assumption reinsurance transaction that is controlled by section 809(d)(12) and *section 162*. The Commissioner argues here for an "acquisition

It is no more correct to isolate and focus on only one aspect of indemnity reinsurance (*viz.*, the expectation by the insurer of receiving future premium income in consideration for the insurance it provides) in order to resolve the issue presented here than it is to isolate and focus on only that same aspect of directly-written insurance in order to determine the tax treatment of agents' commissions and other expenses incurred in issuing that insurance.[4] In the case of both directly-written insurance and indemnity reinsurance the insurer has incurred expenses in issuing the insurance and expects to receive future premium income from its policyholder in consideration for its insurance coverage. Those facts certainly could not be determinative of the tax treatment of the expenses so incurred. Otherwise, the Commissioner could not agree—as he always has—that the expenses of issuing directly-written insurance are currently deductible.

What is determinative is that both directly-written insurance and indemnity reinsurance are treated by the tax law *solely* as the issuance of insurance, and *not* as the acquisition of an asset, and in each case the expenses incurred by the issuing company are treated *solely* as incurred in issuing such insurance, and *not* in acquiring an asset.[5] Accordingly, such ex-

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of an asset" approach that is controlled by section 809(d)(12) and *section 167* (Comm. Br. at 11).

[4] Obviously, insurance companies insist on receiving future premium income in return for agreeing to share any losses from specified risks. They also expect to make a profit, although that expectation is not necessarily realized.

[5] The cases relied on by the Commissioner (Comm. Br. at 16-20), which require capitalization and amortization of acquisition expenses, including amounts paid by insurance companies to pur-

penses are deductible when incurred under the taxing pattern prescribed in Part I of Subchapter L. In the case of indemnity reinsurance, section 809(c)(1) mandates this result for ceding commissions and implements the clearly articulated intent of Congress that an indemnity reinsurer be "treated substantially in the manner he would be if he had issued the [rein-

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chase insurance contracts from other insurance companies in assumption reinsurance transactions, are inapposite to the present case. The Tax Court and the Seventh Circuit so concluded when the Commissioner relied on many of the same cases to support his position before those courts. As the Tax Court observed:

> Respondent [the Commissioner] cites to us numerous cases which require capitalization and amortization of acquisition expenses. However, *such cases apply when an asset is acquired, not when insurance is sold. Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit, such is also true when an insurance company issues a single policy to an individual. Yet, the expenses relating to that policy are currently deductible.* While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. *In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet, the Code treats one* [*indemnity reinsurance*] *as the issuance of insurance and one* [*assumption reinsurance*] *as* [*the*] *acquisition of an asset. That makes all the difference.*

Beneficial Life Insurance Co. v. Commissioner, 79 T.C. 627, 647-48 (1982) (emphasis added). *See also Merit Life Insurance Co. v. Commissioner*, 853 F.2d 1435, 1441-43 (7th Cir. 1988), *aff'g* 52 T.C.M. (CCH) 658 (1986), *petition for cert. pending*, No. 88-955.

sured] insurance policy (or part thereof) directly." S. Rep. No. 291, *supra*, at 38-39, 1959 U.S. Code Cong. & Admin. News at 1613-14.

The Commissioner evidently does not like this result. Thus, in advancing his position, he disregards the fact that indemnity reinsurance and directly-written insurance are inherently the same and that Congress treated both as the issuance of insurance in Part I of Subchapter L. The Commissioner also dismisses the differences between indemnity reinsurance and assumption reinsurance as irrelevant. Those differences, however, are fundamental, substantive differences that are recognized by the federal income tax law.[6] The tax law treats indemnity reinsurance, like directly-written insurance, as a continuing insurance relationship between the company issuing the insurance (the reinsurer) and its policyholder (the ceding company). In contrast, the tax law treats an assumption reinsurance transaction as a purchase by an insurance company of insurance contracts from another insurance company.[7]

The Commissioner's refusal to acknowledge this

[6] Those differences are also recognized by the law governing insurance. The Commissioner is wrong in characterizing them as mere "differences in duration and form." Brief for the Petitioner ("Pet. Br.") at 2-4, 10-21.

[7] In contrast to the tax treatment of the expenses of issuing indemnity reinsurance and directly-written insurance, Treas. Reg. § 1.817-4(d)(2)(ii) requires the amount paid to acquire insurance contracts in an assumption reinsurance transaction to be treated as a "deferred expense" to be deducted over the useful life of the contracts acquired.

treatment by the Code appears to be based largely on his belief that the current deduction of ceding commissions incurred in issuing indemnity reinsurance would be an "extraordinary" result (Comm. Br. at 35) and would "grossly distort" (Comm. Br. at 8, 17) income by "mismatching" income to be received in the future and the costs of acquiring that income.[8] The Commissioner never explains why the current deduction of a selling expense in respect of indemnity reinsurance should be considered as "extraordinary" or as resulting in a "gross distortion" of income, when he acknowledges that such a deduction is obtained in respect of directly-written insurance. No sound explanation can be given. In both cases Part I of Subchapter L allows a life insurance company to reduce currently its underwriting income by the expenses incurred in issuing its insurance.

II.

The Commissioner insists that, in order to override the "tax principles generally applicable to all other

[8] The Commissioner also complains (Comm. Br. at 42) that the result urged by Colonial would invite "abuses" because it would result in underwriting losses in the year the indemnity reinsurance is issued and may encourage insurance companies to use indemnity reinsurance "to defer taxation indefinitely on *all* of their underwriting gains" (emphasis in original). That complaint ignores the taxing pattern of Part I of Subchapter L and disregards the fact that indemnity reinsurance is essential to the ability of the insurance industry to control risks effectively. It also erroneously assumes, contrary to the testimony of Colonial's expert witness (Tr. at 58-60), that indemnity reinsurers (as well as direct insurers against which logically the same complaint could lie) have an infinite amount of surplus to support mounting losses that is unregulated by state insurance authorities and that is available to them to play a "shell game."

taxpayers," specific language in Part I of Subchapter L, the regulations, or the legislative history permitting the current deduction of ceding commissions incurred in issuing indemnity insurance would be required. The Commissioner has it backwards. The taxing pattern of Part I of Subchapter L, and *not* "tax principles generally applicable to all other taxpayers," applies here. That taxing pattern requires that expenses incurred in issuing insurance be deducted currently. Therefore, specific language in the Code would be required in order to reach the contrary result urged by the Commissioner in this case.

A.

There is, however, specific language in a provision in Part I of Subchapter L—section 809(c)(1)—which allows a life insurance company to deduct currently ceding commissions it incurs in issuing indemnity reinsurance. Section 809(c)(1) expressly provides that "return premiums" and "premiums and other consideration arising out of reinsurance ceded" are to be deducted from the gross amount of premium income determined under that section. Section 1.809-4(a)(1)(ii) of the Treasury Regulations expressly provides that "amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums." Ceding commissions incurred in issuing indemnity reinsurance are "amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded." The fact that such commissions are incurred simultaneously with the receipt of a premium from the ceding company makes them no less a "return premium" than

if they were incurred at a later point in time. Contrary to the Commissioner's contention, there is absolutely nothing in the statute, the regulations thereunder, or the relevant legislative history that limits the definition of "return premiums" in the case of indemnity reinsurance *solely* to experience refunds.[9]

A few years after the Tax Court decided *Beneficial Life*, Congress enacted extensive revisions to Part I of Subchapter L.[10] Those revisions did not alter the substance of section 809(c)(1) insofar as it pertains to the treatment of ceding commissions incurred in issuing indemnity reinsurance.[11] If Congress had been

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[9] The fact that the legislative history of section 820, referred to by the Commissioner (Comm. Br. at 31), contains the statement that experience refunds under indemnity reinsurance are to be excluded from premium income in no way supports his view that this is the *only* situation in which amounts of premiums or other consideration returned to another life insurance company in respect of indemnity reinsurance reduce premiums. Indeed, the legislative history of section 809(c)(1) refutes any such suggestion. Thus, the Senate Finance Committee Report provides that "return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract" are to be included in "return premiums." S. Rep. No. 291, *supra*, at 54, 1959 U.S. Code Cong. & Admin. News at 1629.

Furthermore, there is no support in the statute for the Commissioner's view that the phrase "premiums and other consideration arising out of reinsurance ceded," which appears in section 809(c)(1), applies *solely* to ceding companies (and not to reinsurers) in indemnity reinsurance transactions.

[10] Deficit Reduction Act of 1984 ("DEFRA"), Pub. L. No. 98-369, § 211, 98 Stat. 494, 720.

[11] Nor did those revisions alter the substance of section

concerned that the Tax Court misinterpreted section 809(c)(1) as it applies to such ceding commissions, it could have legislated a different result. Congress chose not to do so.

B.

Ceding commissions and other expenses incurred in issuing indemnity reinsurance are deductible currently under sections 809(d)(12) and 162, just as agents' commissions and other expenses incurred in issuing directly-written insurance are deductible currently under those provisions. The Commissioner disagrees (Comm. Br. at 36-38) and contends that any analogy between ceding commissions incurred in issuing indemnity reinsurance and agents' commissions incurred in issuing directly-written insurance is a "false analogy."[12]

809(d)(12) or section 818(a) as they pertain to the issue in this case. The successors to sections 809(c)(1), 809(d)(12), and 818(a) that were enacted by DEFRA are found in sections 803, 805(a)(8), and 811(a) of the Internal Revenue Code of 1986 now in effect.

[12] The Commissioner suggests that somehow there is a "false analogy" because of the number of parties involved in each transaction: in indemnity reinsurance there are typically two parties to the transaction (the issuer of the insurance and the company to which the insurance is issued), whereas in directly-written insurance there are typically three parties (the issuer of the insurance, the person to whom the insurance is issued, and a sales agent). In fact, the indemnity reinsurance in this case involved three parties: the issuer of the insurance, the company to which the insurance was issued, and a sales agent to which a finder's fee that is also at issue here was paid. This fact has not affected the Commissioner's position that the finder's fee is not currently deductible. Moreover, having acknowledged that an agent's commission is deductible currently where a third party purchases an insurance policy, surely the Commissioner would not suggest that, where an agent purchases an insurance policy

That contention is unfounded and has been specifically rejected by the Tax Court and by the Seventh Circuit. Indeed, the United States Court of Claims also had occasion to observe:

> When plaintiff [the ceding company] reinsured [in an indemnity reinsurance transaction] the business with North America [the reinsurer] it took on, as between it and North America, the character of agent, and as such it was entitled to a commission on the amount reinsured with North America.

Colonial Surety Co. v. United States, 178 F. Supp. 600, 602 (Ct. Cl. 1959).[13]

The Commissioner states that section 809(d)(12) "embraces only the usual range of 'ordinary and nec-

for himself (*i.e.*, where only *two* parties are involved), the agent's commission paid to him would not be deductible currently. The point is that the number of parties involved in indemnity reinsurance and in directly-written insurance has nothing to do with determining the tax treatment of the expenses of issuing each type of insurance.

[13] The Commissioner also asserts that the fact that agents' commissions are compensation income to the sales agents for selling directly-written insurance on behalf of insurance companies somehow determines the timing of the deduction by the direct insurer for such commissions. Implicit in this assertion is the erroneous premise that the timing of the deduction of an amount by the payor is controlled by the nature of that amount to the recipient. This assertion also disregards the fact that the ceding company must take into income the full amount of the ceding commission in the year the indemnity reinsurance is issued.

essary' deductions, and that provision in no way comprehends the capital payments embodied in a ceding commission."[14] This statement is inconsistent with Treas. Reg. § 1.817-4(d)(2)(ii) which makes it quite clear that the amount paid to acquire insurance contracts in an assumption reinsurance transaction, *to the extent it is an "ordinary and necessary" business expense*, must be treated as a "deferred expense," a portion of which is allowed as a deduction under sections 809(d)(12) and 162 over the reasonably estimated life of the contracts acquired.[15] Certainly, if the amount paid to acquire insurance policies in an assumption reinsurance transaction can constitute an "ordinary and necessary" business expense under the Commissioner's own regulations, albeit one that must be deferred, the Commissioner cannot seriously contend here that the ceding commission incurred in issuing indemnity reinsurance cannot also constitute an "ordinary and necessary" business expense, albeit one that must be deducted in full currently.[16]

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[14] Comm. Br. at 9.

[15] To our knowledge, the Commissioner has never previously contended, in contradiction of his own regulation, that the amount paid by the purchasing company in an assumption reinsurance transaction for the acquisition of insurance contracts (to the extent such amount is paid for the insurance contracts and not for assets such as goodwill that have no determinable useful life) is other than an "ordinary and necessary" business expense which must be treated as a "deferred expense" under sections 809(d)(12) and 162.

[16] Indemnity reinsurance is an integral part of the day-to-day business of the insurance industry (*see, e.g.*, Tr. at 27 and Brief for the *Amici Curiae* in Support of Petitioner at 4-10) and the ceding commission incurred in issuing indemnity reinsurance is nothing more than a normal, routine expense incurred by an

C.

The Commissioner would have this Court believe that there is a rule of "accrual accounting" which requires a life insurance company to capitalize ceding commissions incurred in issuing indemnity reinsurance and that therefore section 818(a) does not require the application of NAIC accounting in the present case (Comm. Br. at 10, 38-39).[17] The Commissioner is wrong.

The Commissioner is also wrong in contending that the rule requiring "acquisition costs of a future benefit" to be capitalized is a rule of "accrual accounting." Moreover, his reliance on Treas. Reg. § 1.461-1(a)(2) as support for his contention is misleading. The requirement to classify an expenditure as a currently deductible expense or as a capital item is *not* a rule imposed by "accrual accounting." It is a requirement imposed by Treas. Reg. § 1.446-1(a)(4)(ii) and is not dependent on the particular accounting method a taxpayer uses. This requirement exists regardless of

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indemnity reinsurer in issuing its insurance to another insurance company.

[17] The Commissioner also contends (Comm. Br. at 40 n.29) that Colonial's NAIC accounting argument—

> ultimately proves too much, for the NAIC procedures on which it relies appear equally to require a first-year write off, not only of ceding commissions paid in indemnity reinsurance, but also of those paid in assumption reinsurance as well . . . .

Apparently the Commissioner has ignored the fact that a specific provision in his own regulations overrides NAIC accounting regarding assumption reinsurance transactions. That is a critical distinction under section 818(a).

whether a taxpayer is on the accrual method of accounting, the cash method of accounting, or any other method of accounting. It is restated not only in the regulation applicable to accrual method taxpayers that is cited and quoted by the Commissioner (Treas. Reg. § 1.461-1(a)(2)), but also in the regulation applicable to cash method taxpayers (Treas. Reg. § 1.461-1(a)(1)) that is *not* cited or quoted by the Commissioner.

Thus, both Treas. Reg. § 1.461-1(a)(1) (applicable to cash method taxpayers) and Treas. Reg. § 1.461-1(a)(2) (applicable to accrual method taxpayers) refer, in virtually identical terms, to the requirement imposed by Treas. Reg. § 1.446-1(a)(4)(ii) that any expenditure resulting in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. The Commissioner's suggestion that the reference to this requirement in the regulation applicable to accrual method taxpayers (Treas. Reg. § 1.461-1(a)(2)) means that such a requirement is a rule imposed by the accrual method of accounting, which must therefore override NAIC accounting, is baseless.

Moreover, this case does not involve "acquisition costs of a future benefit," as the Commissioner asserts. It involves the issuance of indemnity reinsurance and the tax treatment of ceding commissions incurred in issuing that insurance. The rules of accrual accounting do not speak to the question of the character, as a currently deductible expense or as an amortizable capital expenditure, of those ceding commissions.[18] Accordingly, section 818(a) requires NAIC

[18] Nor do accrual accounting rules address the character, as a currently deductible expense or as an amortizable capital expenditure, of the commissions and other expenses incurred in issuing directly-written insurance. The Commissioner concedes this point when he acknowledges that such expenses are deductible currently. Thus, there is no logical basis for the Commissioner to assert here that accrual accounting rules require the capitalization of ceding commissions incurred in issuing indemnity reinsurance.

accounting to control the federal tax treatment in the present case.[19]

The Commissioner also is wrong and misleading in claiming (Comm. Br. at 18, 41) support for his position in *The Industry Audit Guide of Stock Life Insurance Companies* (1972) (the "Audit Guide").[20] The Audit Guide prescribes generally accepted accounting principles ("GAAP") for stock (not mutual) life insurance companies which are utilized to produce financial statements which fairly present the financial condition of the business enterprise. Because GAAP requires ceding commissions incurred in issuing indemnity reinsurance and amounts paid in assumption reinsurance transactions to be treated in the same manner (*viz.*, to be capitalized and amortized), the Commissioner would like this Court to conclude that, for federal income tax purposes, there is no distinction between indemnity reinsurance and assumption reinsurance or between the treatment of such commissions and such amounts. He fails to point out that GAAP also requires agents' commissions and other

[19] Pet. Br. at 26-30.

[20] The Audit Guide was prepared by the Committee on Insurance Accounting and Auditing of the American Institute of Certified Public Accountants "to provide guidance to independent auditors in examining and reporting on financial statements of life insurance companies" (Audit Guide at 1).

expenses incurred in issuing directly-written insurance to be capitalized and not deducted currently (*Id.* at 71-74). The Commissioner does not contend that the federal income tax treatment of such expenses is governed by GAAP. This is because GAAP does not control the tax treatment of expenses incurred in issuing directly-written insurance any more than GAAP controls the tax treatment of ceding commissions incurred in issuing indemnity reinsurance.[21]

This Court, which has previously recognized that "[l]ife insurance accounting is a world unto itself" and that "mechanical application of ordinary accounting principles will not necessarily yield a sound result,"[22] should not countenance the Commissioner's disregard of the provisions of Part I of Subchapter L which are based on NAIC accounting. Resort to some purported "general" or "fundamental" tax rule that may be applicable to "any other taxpayer, in any other setting" to determine the federal income tax treatment of ceding commissions incurred in issuing indemnity reinsurance would yield an unsound result

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[21] *See* Audit Guide at 65. In fact, Appendix C of the Audit Guide, which specifically concerns deferred income taxes, notes that one of the most significant timing differences between GAAP and the federal income tax rules applicable to insurance companies results from the deferral and amortization under GAAP of various costs they incur, such as the expenses of issuing directly-written insurance and indemnity reinsurance (*Id.* at 152).

[22] *United States v. Consumer Life Insurance Co.*, 430 U.S. 725, 739 n.18 (1977). *See also Beneficial Life*, 79 T.C. at 647 ("An understanding of that difference [between the tax consequences of indemnity reinsurance and assumption reinsurance] must flow from the understanding of the complex and somewhat unique rules applicable to the insurance industry.").

contrary to Part I of Subchapter L, its legislative history, and the regulations thereunder.

For these reasons and those set forth in our opening brief, the judgment of the court of appeals should be reversed, and the case should be remanded with instructions to affirm the Tax Court's judgment.

Respectfully submitted,

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APPENDIX

TREASURY REGULATIONS

Treas. Reg. § 1.446-1(a)(4)(ii) (26 C.F.R. § 1.446-1(a)(4)(ii))

§ 1.446-1. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE.

* * *

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

* * *

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

Treas. Reg. §§ 1.461-1(a)(1) and (2) (26 C.F.R. §§ 1.461-1(a)(1) and (2))

§ 1.461-1. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.

(1) TAXPAYER USING CASH RECEIPTS AND DISBURSEMENTS METHOD - Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures.

(2) TAXPAYER USING AN ACCRUAL METHOD - Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability to A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see § 1.461-2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.

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IN THE
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OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

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BRIEF FOR THE AMERICAN COUNCIL OF LIFE INSURANCE AND THE NATIONAL ASSOCIATION OF LIFE COMPANIES AS AMICI CURIAE IN SUPPORT OF PETITIONER

This brief is submitted with the written consent of counsel to both parties filed with the Clerk of the Court.

INTEREST OF THE AMICI CURIAE

The American Council of Life Insurance ("ACLI") is a trade association with 646 life insurance company members. These member companies account for 93 percent of all the life insurance business in force in the United States and hold 93 percent of the total assets of

all United States life insurance companies. The National Association of Life Companies ("NALC") is a trade association with over 600 small and medium-sized life insurance company members, many of which are also members of the ACLI.

The issue in this case is whether a life insurance company is entitled to deduct currently, in computing its taxable income, the ceding commissions it incurs in issuing indemnity reinsurance to another life insurance company. As is explained in the argument, *infra*, indemnity reinsurance is essential to the operation of the life insurance business. Indemnity reinsurance enables all life insurance companies to distribute adequately their risks and small life insurance companies to grow and to compete with large life insurance companies.

Because of the vital role of indemnity reinsurance, member companies of the ACLI and the NALC regularly engage in indemnity reinsurance transactions. The treatment of ceding commissions affects not only the tax liability of the companies issuing indemnity reinsurance, but also the cost to companies obtaining the indemnity reinsurance coverage. Thus, the issue in this case is of major importance to the members of the ACLI and the NALC.

SUMMARY OF ARGUMENT

The initial expenses incurred by a life insurance company in issuing an insurance policy are deductible in the year those expenses are incurred. That result should not change when the insurance company is insuring another insurance company rather than members of the public. When a life insurance company causes a policy to be reinsured under an indemnity reinsurance contract, the reinsuring company issues insurance coverage to the original company, thereby insuring the original company for part of its risk under the original policy. The initial expenses incurred by the reinsuring company in issuing

its indemnity reinsurance contract to the original company include a payment to that company. This payment is known as a "ceding commission."

The initial expenses incurred by the original company in issuing its insurance policies are currently deductible. The reinsuring company also should be able to deduct currently its initial expenses, including its ceding commissions. The legislative history of the Life Insurance Company Income Tax Act of 1959, Pub. L. No. 86-69, 73 Stat. 112 (the "1959 Act"), reveals that Congress intended this treatment, and section 809(c)(1)[1] provides for it. The Commissioner's contention that ceding commissions paid by the reinsurer should not be deductible currently, but rather should be capitalized, reflects a lack of understanding of the nature and purpose of indemnity reinsurance as well as a failure to recognize the differences between indemnity reinsurance and assumption reinsurance. Furthermore, current deductibility of the initial expenses incurred by a reinsurer ensures, as Congress intended, that the Federal income tax treatment of indemnity reinsurance is neutral—companies are neither penalized nor rewarded by the tax system for obtaining indemnity reinsurance coverage.

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[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1954 (26 U.S.C. (1976)), as amended and in effect during 1975 and 1976. The provisions of part I of subchapter L of the Code, which govern the taxation of life insurance companies, were extensively amended by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (the "1984 Act"). However, that legislation did not alter the substance of those provisions insofar as they pertain to the treatment of ceding commissions. Thus, this Court's decision will control the treatment of ceding commissions under current law as well as under prior law.

ARGUMENT

A LIFE INSURANCE COMPANY IS ENTITLED TO DEDUCT CURRENTLY THE CEDING COMMISSIONS IT INCURS IN ISSUING INDEMNITY REINSURANCE CONTRACTS

I. Introduction

A. *The Purpose of Indemnity Reinsurance*

When an insurance policy is issued, the policyholder is colloquially said to have "insurance" because he has shifted a risk from himself to the insurance company. However, insurance does not consist merely of shifting a risk. Rather, a fundamental part of the business of insurance is the spreading of the risks which have been shifted to the insurance company. It is to achieve this spreading of risks that a form of insurance known as *indemnity reinsurance* is continually employed by insurers.

Were a life insurance company to insure the life of only one person, the company simply would be betting on the life expectancy of that person. Insuring a large number of lives avoids this gamble. The reason for this is that the greater the number of lives insured, the less the actual number of deaths in the group in any given period will differ from the predicted number of deaths for that period. *See generally* K. Black, Jr. & H. Skipper, Jr., *Life Insurance* 13-14 (11th ed. rev. 1987). This spreading of risk through the insurance of a large number of persons is known as "risk distribution." *See Helvering v. LeGierse*, 312 U.S. 531 (1941).

Effective risk distribution requires not only a sufficiently large pool of insureds, but also limitations on the amount of risk that an insurance company accepts with respect to any one insured. This is because a life insurance company's risk with respect to an insured life is determined not only by the probability of death in any given period, but also by the amount of the death benefit it will pay. Every life insurance company, therefore, sets a limit on the maximum amount of coverage it can safely maintain with respect to any one insured. Steffen, "Reinsurance," in *Life and Health Insurance Handbook* 991, 992 (D. Gregg & V. Lucas eds., 3d ed. 1973); K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431. This limit is often referred to as the company's "retention" limit. A company's retention limit will depend in part on the overall size of the company. Generally speaking, a larger company will have a larger surplus than a smaller company and thus will have a greater ability to absorb unexpected fluctuations in mortality experience. Consequently, a larger life insurance company will generally have a higher retention limit than will a smaller company. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431.

Were this the end of the story, only large insurance companies would be able to write policies covering large risk amounts, and small companies would be relegated to writing small policies. In addition, some risk amounts might be so large that they would not be capable of coverage by any one company. It is indemnity reinsurance which prevents this from being the case.

Indemnity reinsurance is insurance coverage taken out by an insurance company on risks that it has originally insured. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431. By means of indemnity reinsurance, a company that issues insurance policies to the public (known as the "direct writer" or the "ceding company") can issue policies in the amounts desired and yet maintain an adequate distribution of risk. For example, a small life insurance company which has determined that it cannot safely carry a risk of more than $30,000 per insured may receive an application from an individual who desires coverage of $50,000. Through indemnity reinsurance, the company can nevertheless issue the $50,000 policy, retaining $30,000 of risk and insuring the remaining $20,000 of risk under an indemnity reinsurance contract. Thus, when the insured individual dies, al-

though the direct writer will pay the entire death benefit of $50,000, the reinsurer will pay the direct writer $20,000 under the indemnity reinsurance contract. *See* Rohm, *Life Reinsurance*, 5 Proc. Conf. Actuaries in Pub. Prac. 100, 103-04 (1956).

While the primary purpose of indemnity reinsurance is to achieve adequate risk distribution and thereby prevent the concentration of too much risk in one company, indemnity reinsurance also serves other purposes. Indemnity reinsurance often is used to reduce the drain on a company's surplus caused by writing new business, thereby allowing small and growing life insurance companies to continue issuing insurance. *See United States v. Consumer Life Ins. Co.*, 430 U.S. 725, 737-38 (1977) (explaining the use of reinsurance to reduce surplus drain). In addition, indemnity reinsurance helps to stabilize the mortality experience of the ceding company. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431 (discussing the uses of indemnity reinsurance).

In short, indemnity reinsurance is essential to the operation of the insurance business. Because of its vital role, indemnity reinsurance occurs continually among life insurance companies. In 1987 alone, the life insurance industry reinsured $443 billion of life insurance coverage. A.M. Best Co., *Best's Aggregates and Averages: Life-Health* 49 (7th ed. 1988).[2]

B. *The Operation of Indemnity Reinsurance*

In an indemnity reinsurance transaction, the direct writer buys insurance coverage from another insurance company, the reinsurer, on risks the direct writer has accepted under its policies. Kramer, "The Nature of Reinsurance," in *Reinsurance* 1, 5 (R. Strain ed. 1980). The indemnity reinsurance contract is a separate contract of insurance between the direct writer and the reinsurer. *See Merit Life Ins. Co. v. Commissioner*, 853 F.2d 1435, 1441 (7th Cir. 1988), *petition for cert. filed*, 57 U.S.L.W. 3434 (U.S. Dec. 8, 1988) (No. 88-955); *Oxford Life Ins. Co. v. United States*, 790 F.2d 1370, 1376 (9th Cir. 1986); *Cologne Life Reinsurance Co. v. Commissioner*, 80 T.C. 859, 862 (1983), *aff'd by summary order*, 732 F.2d 141 (2d Cir. 1984) (unpublished opinion); *Beneficial Life Ins. Co. v. Commissioner*, 79 T.C. 627, 646 (1982); Kramer, *supra* p. 6, at 4; K. Thompson, *Reinsurance* 4 (3d ed. 1951).

The indemnity reinsurance contract between the direct writer and the reinsurer is in addition to the original insurance contract between the ceding company and its policyholder; the indemnity reinsurance contract does not supplant or replace that original contract. Significantly, the indemnity reinsurer assumes *no* liability to the policyholders of the direct writer. *See, e.g., Merit Life*, 853 F.2d at 1436; *Lincoln Nat'l Life Ins. Co. v. United States*, 582 F.2d 579, 593 (Ct. Cl. 1978). In short, indemnity reinsurance is "insurance for the inurer." K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431.[3]

Although all indemnity reinsurance contracts share certain common characteristics, specific terms can vary considerably from one contract to another. For example, some indemnity reinsurance contracts may insure part of the direct writer's risks under insurance policies that the direct writer has already issued, other indemnity reinsurance contracts may insure risks only under policies to be issued by the direct writer in the future, and still other contracts may insure risks under both existing and future policies of the direct writer. *See generally* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 432-33 (dis-

[2] A precise identification of the portion of this reinsurance which is indemnity reinsurance is not possible. Given the purposes of indemnity reinsurance, however, amici believe that the preponderance is indemnity reinsurance.

[3] Indeed, some insurance companies, known as professional reinsurers, have a division or unit that specializes in such "insurance for the insurer." These professional reinsurers often obtain indemnity reinsurance from other reinsurers. Such a reinsurance contract between reinsurers is referred to as a retrocession. *See* Steffen, *supra* p. 5, at 1005.

cussing indemnity reinsurance arrangements). Indemnity reinsurance contracts also differ with respect to the basis on which the contract may be terminated in whole or in part. Like other insurance policies, an indemnity reinsurance contract frequently may be terminated at the instance of the insured party (the direct writer), subject to any restrictions or penalties to which the parties may have agreed. Tax Court Transcript at 39-40, *Colonial Am. Life Ins. Co. v. Commissioner*, 51 T.C.M. (CCH) 1123 (1986) (No. 20384-83).

The reinsurance contracts between petitioner Colonial American Life Insurance Company ("Colonial American"), the reinsurer, and Transport National Life Insurance Company ("Transport"), the direct writer and ceding company, involved two forms of indemnity reinsurance known as conventional coinsurance (or simply coinsurance) and modified coinsurance. *See Colonial Am. Life Ins. Co. v. Commissioner*, 843 F.2d 201, 202 (5th Cir. 1988).[4] In addition, a third type of indemnity reinsurance is generally recognized: yearly renewable term reinsurance. *See Steffen*, *supra* p. 5, 993-99; Rohm, *supra* p. 6, at 100.

C. *The Role of the Ceding Commission*

When a direct writer issues an insurance policy, it receives premium income from the policyholder. In issuing the policy, the direct writer incurs substantial initial expenses, including the selling agent's commission, medical underwriting costs, state premium taxes, and computer and other administrative costs. Likewise, when an indemnity reinsurer issues insurance coverage to a direct writer, the reinsurer receives premium income from

[4] Colonial American and Transport consented, pursuant to section 820 and Treas. Reg. § 1.820-2, to treat the modified coinsurance contracts in the same manner as the conventional coinsurance contracts for Federal income tax purposes. *Colonial Am. Life Ins. Co.*, 843 F.2d at 203. As a consequence of that election, the modified coinsurance contracts are treated the same as the conventional coinsurance contracts. *See Consumer Life Ins. Co.*, 430 U.S. at 747-49.

the direct writer and incurs substantial initial expenses, including an expense referred to in the insurance industry as a ceding commission.

The ceding commission incurred by an indemnity reinsurer in issuing an indemnity reinsurance contract to another insurance company is an initial expense that is analogous to the initial expenses that the direct writer incurs in issuing insurance policies to the public. *See Colonial Surety Co. v. United States*, 178 F. Supp. 600, 602 (Ct. Cl. 1959) (comparing ceding commissions paid by an indemnity reinsurer with agents' commissions paid by a direct writer). The reinsurer pays the ceding commission to the direct writer. The amount of the ceding commission is negotiated between the direct writer and the reinsurer, taking into account a number of elements. *See* Rev. Rul. 79-138, 1979-1 C.B. 359 (describing a ceding commission as being "based upon agents' commissions, premium taxes, license taxes, fees, and administrative and overhead expenses incurred by the [direct] insurer in underwriting the insurance plus a profit factor"); Rev. Rul. 82-69, 1982-1 C.B. 102 (describing a reinsurance contract in which the stated purpose of the ceding commission "was to reimburse [the direct writer] for agents' commissions and other expenses associated with selling and maintaining the reinsured policies that were incurred by [the direct writer] before the effective date of the reinsurance agreement"); Tax Court Transcript at 5, 33-34, 36-39, 50-51, *supra* p. 8 (describing ceding commissions as taking into account a variety of elements, including the expenses incurred by the direct writer and the anticipated profit to the reinsurer).

The role of the ceding commission in reimbursing the initial expenses incurred by the direct writer in issuing insurance contracts to its insureds has been recognized by this Court. *See Consumer Life Ins. Co.*, 430 U.S. at 746

(describing the ceding commission as an amount paid by the reinsurer "to cover the insurer's overhead.") Similarly, one commentator, while noting the various elements that are reflected in the ceding commission, has summarized its function in these terms:

> In summary, the economic function of reinsurance commissions may be described as follows: Basically, reinsurance commissions constitute a refund of the operating expenses incurred by the direct insurer for the business reinsured and usually included in the calculation of the original gross premium.

1 K. Gerathewohl, *Reinsurance Principles and Practices* 245 (1982); *see also* K. Thompson, *supra* p. 7, at 85 ("The theory behind the giving of a commission to the reassured is, of course, to help the reassured in his expenses, particularly in connection with the acquisition cost of the business.").

D. *Assumption Reinsurance Distinguished*

In contending that indemnity reinsurance ceding commissions should be capitalized, the Commissioner has for this purpose equated indemnity reinsurance with a sale transaction called "assumption reinsurance." *See, e.g.*, Brief for Appellant at 35-38, *Colonial Am. Life Ins. Co. v. Commissioner*, 843 F.2d 201 (5th Cir. 1988) (No. 87-4492). In its holding in this case, the Fifth Circuit Court of Appeals appears to have accepted the validity of this equation. *See Colonial Am. Life Ins. Co.*, 843 F.2d at 205. Amici respectfully submit that the Commissioner is wrong in equating indemnity reinsurance with assumption reinsurance. Assumption reinsurance is fundamentally different than indemnity reinsurance.

Indemnity reinsurance is the issuance of an insurance policy by one insurance company to another insurance company. Assumption reinsurance is the sale by one in-

surance company of its insurance policies to another insurance company.[5]

In an assumption reinsurance transaction, the buyer enters into a direct contractual relationship with the policyholders of the seller. Thus, the buyer assumes all obligations under the policies and becomes directly liable to the policyholders. Furthermore, after the sale, the seller is relieved of all liability to the policyholders involved. Such a transaction typically requires the consent of the policyholders and thus constitutes a novation. *See Merit Life*, 853 F.2d at 1436; Treas. Reg. § 1.809-5 (a)(7)(ii) (defining assumption reinsurance). *See generally* Kramer, *supra* p. 6, at 16-17 (describing the "special case" of assumption reinsurance, referred to therein as "portfolio reinsurance").

An assumption reinsurance transaction is recognized as a sale for both tax[6] and state regulatory accounting

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[5] In an assumption reinsurance transaction, an insurance company commonly agrees to sell all of its in-force insurance policies to another insurance company. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431 n.6; Steffen, *supra* p. 5, at 1003-4. In some cases, rather than disposing of its entire in-force business, the insurance company may sell either a line of business it no longer desires to write, *e.g.*, group term contracts, or policies in a certain geographic area in which it no longer desires to do business. *See* K. Black, Jr. & H. Skipper, Jr., *supra* p. 4, at 431 n.6.

[6] *See* Treas. Reg. § 1.817-4(d). The fundamental differences between indemnity and assumption reinsurance were recently reaffirmed in connection with the revisions made by Congress to Part I of Subchapter L in the 1984 Act:

> The Code distinguishes between indemnity reinsurance (or reinsurance ceded) and assumption reinsurance. The first is an arrangement whereby the ceding company remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. The second is an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the ceding company. *Whereas an indemnity reinsurance contract describes a continuing insurance relationship between the*

purposes.[7] Its character as a sale is underscored by the fact that, unlike an indemnity reinsurance agreement, an assumption reinsurance agreement cannot be cancelled after it becomes effective.

Because assumption reinsurance entails a new insurance company replacing the original insurance company, regulatory approval, as well as the approval of the policyholders, is generally required before such a transfer can occur. *See* Kramer, *supra* p. 6, at 17. These requirements make assumption reinsurance transactions difficult to effectuate. Assumption reinsurance transactions are thus extraordinary, rather than ordinary, transactions in the life insurance business.

In sum, assumption reinsurance is not the issuance by one insurance company of a separate insurance contract to another insurance company, but rather involves one insurance company replacing another. In indemnity reinsurance, on the other hand, a separate contract of insurance is issued by one insurance company to another, and the policyholders of the reinsured policies are not parties. *See* Kramer, *supra* p. 6, at 6. Indeed, they rarely are aware of the existence of the indemnity reinsurance contract. In unequivocal terms, the Courts of

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ceding company and the reinsurer, an assumption reinsurance contract is considered a sale of a block of business.

Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 633 (Joint Comm. Print 1984) (emphasis added).

[7] In accordance with practices approved by the National Association of Insurance Commissioners ("NAIC"), when a group of policies is transferred in an assumption reinsurance transaction, all accounting for it is removed from the NAIC annual statement of the selling company. In contrast, the reserves for policies covered by indemnity reinsurance remain on the direct writer's annual statement, with credit being given for the reinsurance coverage that is in effect. *See* Nat'l Ass'n Ins. Commissioners, *Annual Statement Instructions: Life, Accident and Health* 10-1 (1984) (describing the treatment of indemnity reinsurance).

Appeals for the Seventh and Ninth Circuits, as well as the United States Tax Court, have recognized the essential distinction between indemnity reinsurance, on the one hand, and an assumption reinsurance transaction on the other. *Merit Life*, 853 F.2d at 1441; *Oxford Life*, 790 F.2d at 1376 & n.6; *Beneficial Life*, 79 T.C. at 636, 645-46. In the words of the Seventh Circuit Court of Appeals:

> By its nature, an indemnity reinsurance transaction is, from the perspective of the reinsurer . . . the sale of an insurance policy by the reinsurer to the ceding company. Economically, it is substantially the same as the sale of any other policy. In contrast, assumption reinsurance is by its nature the purchase of already issued insurance policies . . . .

Merit Life, 853 F.2d at 1441.

E. *Summary*

Indemnity reinsurance is insurance coverage issued by one insurance company, the reinsurer, to another, the direct writer. The reinsurer insures the direct writer for part of the risk the direct writer has accepted under insurance policies it has issued to the public. Indemnity reinsurance thus is issued through a separate insurance contract between the direct writer and the reinsurer. When an indemnity reinsurer issues an indemnity reinsurance contract, it incurs substantial initial expenses, including a ceding commission. The ceding commission is analogous to the initial expenses, such as agents' commissions, that a direct writer incurs in issuing its insurance policies. Indemnity reinsurance is continually issued as a necessary part of the life insurance business.

On the other hand, unlike indemnity reinsurance, an assumption reinsurance transaction is an extraordinary event involving the sale by one insurance company of some or all of its insurance policies to another insurance company. An assumption reinsurance transaction is

recognized not as the issuance of insurance coverage, but as the purchase of part or all of a life insurance business.

II. Indemnity Reinsurance Ceding Commissions Are Currently Deductible Expenses

A. *Ceding Commissions Are Initial Expenses of an Indemnity Reinsurer and Congress Intended Them to be Deductible Just as the Initial Expenses of a Direct Writer Are Deductible*

The ceding commission paid by a reinsurer under an indemnity reinsurance contract is an initial expense incurred in issuing an insurance contract, just as the agent's commission and other initial expenses of the direct writer are expenses incurred in issuing an insurance contract. The ceding commission serves the same purposes as the initial expenses of the direct writer. It is indisputable that the initial expenses of a direct writer are deductible when incurred.[8] Nevertheless, the Commissioner contends that a substantial portion of the initial expenses of the reinsurer, the ceding commissions, must be capitalized. Amici respectfully submit that the Commissioner's contention is wrong.

Both the direct writer's initial expenses and the indemnity reinsurer's ceding commissions are common, ordinary, day-to-day expenses of insurance companies issuing insurance contracts. As the Seventh Circuit Court of Appeals observed in holding that indemnity reinsurance ceding commissions are deductible:

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[8] *See, e.g.*, S. Prt. 169 (Vol. I), 98th Cong., 2d Sess. 555 (1984); H.R. Rep. No. 432 (Part II), 98th Cong., 2d Sess. 1428 (1984), *reprinted in* 1984 U.S. Code Cong. & Admin. News 697, 1073; S. Rep. No. 1428, 88th Cong., 2d Sess. 4 (1964), *reprinted in* 1964 U.S. Code Cong. & Admin. News 3586, 3590; H.R. Rep. No. 1412, 88th Cong., 2d Sess. 4 (1964), *reprinted in* 1964-2 C.B. 838, 840; S. Rep. No. 291, 86th Cong., 1st Sess. 7 (1959), *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1582; H.R. Rep. No. 34, 86th Cong., 1st Sess. 4 (1959), *reprinted in* 1959-2 C.B. 736, 738; *Beneficial Life*, 79 T.C. at 647; *Merit Life*, 853 F.2d at 1442.

> Whether or not an insurance company sells insurance to an individual or to another insurance company, each involves the issuance of new policies and the transfer of a risk and, under the Code, the commission expenses incurred in either transaction, whether paid to insurance agents in the case of individual policies or to ceding companies in the case of reinsurance, are deductible in the year of their payment.

Merit Life, 853 F.2d at 1442. The Tax Court has consistently held this view since it first considered the question seven years ago. *See Beneficial Life*, 79 T.C. 627; *Modern Sec. Life Ins. Co. v. Commissioner*, 51 T.C.M. (CCH) 188 (1985), *rev'd sub nom. Modern Am. Life Ins. Co.*, 818 F.2d 1386 (8th Cir. 1987); *Individual Life Assurance Co. v. Commissioner*, 51 T.C.M. (CCH) 1028 (1986), *revised per memorandum sur order* (Oct. 8, 1987); *Colonial Am. Life Ins. Co. v. Commissioner*, 51 T.C.M. (CCH) 1123 (1986), *rev'd*, 843 F.2d 201 (5th Cir. 1988); *Merit Life Ins. Co. v. Commissioner*, 52 T.C.M. (CCH) 658 (1986), *aff'd*, 853 F.2d 1435 (7th Cir. 1988), *petition for cert. filed*, 57 U.S.L.W. 3434 (U.S. Dec. 8, 1988) (No. 88-955).

The reasoning of the Seventh Circuit Court of Appeals and the Tax Court reflect the intent of Congress that indemnity reinsurance ceding commissions be treated in the same manner as other initial expenses incurred in issuing an insurance contract. That intent was expressed by Congress in enacting, as part of the 1959 Act, the provisions of the Internal Revenue Code that govern in this case. Specifically, the Report of the Senate Finance Committee stated:

> [C]oinsurance calls for the premium with respect to the insurance reinsured to go to the reinsurer, with the result that *the reinsurer, with respect to this insurance, is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly.* Any expenses incurred by the initial insurer with respect to the policy are

reimbursed by the reinsurer. This form of indemnity reinsurance presents few special tax problems. . . . .

[T]he bill . . . treats modified coinsurance in the same manner as conventional coinsurance; that is, *a policy to the extent reinsured in this manner generally is treated as if it were a policy issued by the reinsurer instead of the initial insurer.*

Thus, premiums, gross investment income, capital gains and losses, reserves, and assets *and expenses which are related to the insurance reinsured are generally treated as received, held, or incurred (as the case may be) by the reinsurer instead of the initial insurer.*

S. Rep. No. 291, *supra* p. 14 note 8, at 38-39 (emphasis added).

The meaning of these statements is clear: Congress intended an indemnity reinsurer to be treated for tax purposes as a direct writer. The Committee Report observes that a policy reinsured under a modified coinsurance contract is to be treated "in the same manner as" a policy reinsured under a conventional coinsurance contract for Federal income tax purposes. *Id.*, at 39. And how is a reinsurer treated under a conventional coinsurance contract? The reinsurer "is treated substantially in the manner he would be if he had issued the insurance policy (or part thereof) directly." *Id.*, at 38-39. Amici submit that the reinsurer can be treated in substantially the same manner as the direct writer only if, like the direct writer, the reinsurer can deduct the initial expenses of issuing its insurance policy. If Congress had intended that an indemnity reinsurer treat its initial expenses in a fundamentally different manner than the direct writer treats its initial expenses, Congress would have so provided. Congress enacted no rule providing for such different treatment, however. To the contrary, as is discussed in the next section, Congress specifically provided that ceding commissions are currently deductible.

B. *Section 809(c)(1) Expressly Allows a Deduction for Indemnity Reinsurance Ceding Commissions*

Given Congress' logical conclusion that the ceding commission paid by an indemnity reinsurer should be afforded the same treatment as the initial expenses of a direct writer, it is not surprising that Congress specifically provided for the current deduction of ceding commissions.[9] Section 809(c)(1) provides that the gross premium income of a life insurance company (Colonial American, in this case) is reduced by "return premiums, and premiums and other consideration arising out of reinsurance ceded" (hereafter referred to as simply "return premiums"). Consistent with the legislative history of section 809(c)(1),[10] the Treasury regulations state:

> The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term

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[9] By treating one type of insurance (indemnity reinsurance) the same as another type of insurance (direct writing), Congress adhered to the basic principle of tax parity between similarly situated taxpayers. Tax parity is a principle which this Court has expressly recognized as a significant factor in determining whether an expense should be capitalized or expensed. *See Commissioner v. Idaho Power Co.*, 418 U.S. 1, 14 (1974); *see also Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979) (citing tax parity in support of allowing a current deduction); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 784 (2d Cir. 1973) (citing tax parity in support of allowing a current deduction). To have allowed a direct writer to deduct currently the initial expenses it incurs in issuing its insurance contracts, while denying such a deduction to an indemnity reinsurer for the initial expenses it incurs in issuing its indemnity reinsurance contracts, would have sanctioned disparate tax treatment between taxpayers who are engaged in the same activity: the issuance of insurance policies. Congress rejected this treatment in enacting the 1959 Act, just as this Court refused to countenance similarly disparate treatment in *Idaho Power*.

[10] S. Rep. No. 291, *supra* p. 14 note 8, at 54; H.R. Rep. No. 34, *supra* p. 14 note 8, at 29-30.

> includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of *premiums or other consideration returned to another life insurance company in respect of reinsurance ceded* shall be included in return premiums.

Treas. Reg. § 1.809-4(a)(1)(ii) (emphasis added). The regulations further provide that "reinsurance ceded" includes indemnity reinsurance transactions, but does not include (for reasons previously explained) assumption reinsurance transactions. *See* Treas. Reg. § 1.809-4(a)(1)(iii).[11]

Section 809(c)(1) and the regulations thereunder thus expressly state that amounts of premiums or other consideration returned to another life insurance company (Transport, in this case) in respect of an indemnity reinsurance transaction are deductible from the gross premium income of the reinsurer (Colonial American).[12] Indemnity reinsurance ceding commissions are precisely that: part of the gross premium income of the reinsurer that is returned to another life insurance company—the direct writer. Consistent with this, the ceding commission constitutes ordinary income to the direct writer, thus effectively reversing prior deductions of initial expenses by the direct writer.

The Seventh Circuit Court of Appeals, and the Tax Court in a series of decisions dating back to 1982, have

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[11] The 1984 Act amended section 809(c)(1), redesignated as section 803(a)(1), to make specific reference to indemnity reinsurance. The legislative history states that the "use of the term 'indemnity reinsurance' in the bill, instead of 'reinsurance ceded' under present law, is not intended to be a substantive change from present law." S. Prt. No. 169, *supra*, p. 14 note 8, at 529.

[12] Technically, section 809(c)(1) reduces the reinsurer's gross premiums by the amount of the ceding commissions it pays. The effect is the same as a deduction. For ease of reference, the section 809(c)(1) reduction is referred to herein as a deduction.

squarely held, consistent with the legislative history of the 1959 Act, that section 809(c)(1) directs the reinsurer in an indemnity reinsurance transaction to reduce the gross amount of its premium income by the ceding commissions it pays. *See Merit Life*, 853 F.2d 1435; *Beneficial Life*, 79 T.C. 627; *Modern Sec. Life Ins. Co.*, 52 T.C.M. (CCH) 188; *Individual Life Assurance Co.*, 51 T.C.M. (CCH) 1028; *Colonial Am. Life Ins. Co.*, 51 T.C.M. (CCH) 1123; *Merit Life*, 52 T.C.M. (CCH) 658. As the Seventh Circuit Court of Appeals stated:

> The Tax Court's reasoning in *Beneficial Life* is supported by the explicit language in section 809(c)(1) and the applicable treasury regulations. Section 809(c)(1) provides that an insurance company's gross income equals "the gross amount of premiums and other consideration . . . less return premiums, and premiums and other consideration arising out of reinsurance ceded." . . . Under section 809(c)(1), "reinsurance ceded" includes commissions from indemnity reinsurance transactions but not from assumption reinsurance transactions.

Merit Life, 853 F.2d at 1439.

The Commissioner, however, has contended that section 809(c)(1)'s reduction of gross income by return premiums serves to reduce only the direct writer's premium income, and not that of the reinsurer. The term, the Commissioner has argued, refers only to amounts that do not truly belong to the direct writer but must be turned over to, or shared with, the reinsurer. *See Merit Life*, 853 F.2d at 1439.

The answer to this contention, in the words of the Seventh Circuit Court of Appeals, is that "[t]here is no provision . . . in section 809 or the applicable treasury regulations which even remotely suggests the Commissioner's interpretation or distinction." *Merit Life*,

853 F.2d at 1439. In fact, the legislative history of section 809(c)(1) recognized that amounts paid by the reinsurer to the ceding company would be reductions in the reinsurer's premium income under section 809(c)(1): "experience refunds paid by the reinsurer to the initial insurer *are treated as reductions in premium income of the reinsurer* and as 'other income' received by the initial insurer." S. Rep. No. 291, *supra* p. 14 note 8, at 39 (emphasis added). This language clearly shows that Congress viewed return premiums as including amounts returned by a reinsurer to the direct writer, and not as limited only to amounts paid by the direct writer to the reinsurer. In sum, section 809(c)(1) provides a clear and logical answer to the question of how to treat indemnity reinsurance ceding commissions—they are currently deductible.[13]

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[13] As discussed in the text, *supra* pp. 17-20, amici believe that ceding commissions are properly deductible under section 809(c)(1). The Seventh Circuit Court of Appeals noted that, alternatively, indemnity reinsurance ceding commissions could be deductible as ordinary and necessary business expenses under section 809(d)(12). (Section 809(d)(12) was redesignated as section 809(d)(11) for tax years beginning after 1976. Pub. L. No. 94-455, § 1901(a)(98), 90 Stat. 1525, 1781.) The Seventh Circuit Court of Appeals explained:

> Alternatively, Merit claims that ceding commissions are deductible under sections 162 and 809(d)(11) as one of many "other deductions" or ordinary business expenses. The Tax Court in *Beneficial Life* noted that ceding commissions in indemnity reinsurance transactions are analogous to currently deductible underwriting expenses of a direct insurer. 79 T.C. at 647. Those deductions are made pursuant to section 809(d)(11). Because we hold that ceding commissions are deductible from gross premiums under section 809(c)(1), we need not address Merit's alternative argument, although we agree with the Tax Court's analogy.

Merit Life, 853 F.2d at 1445 (footnote omitted).

Amici agree that this alternative analysis is valid. Ceding commissions represent recurring ordinary and necessary expenses of

III. The Commissioner Erroneously Equates Indemnity Reinsurance with Assumption Reinsurance

The Commissioner also argues that indemnity reinsurance ceding commissions must be capitalized because under assumption reinsurance agreements the consideration paid for the purchase of life insurance policies must be capitalized. *See* Brief for the Respondent on Petition for a Writ of Certiorari at 6-7, *Colonial Am. Life Ins. Co. v. Commissioner, cert. granted*, 57 U.S.L.W. 3394 (U.S. Dec. 5, 1988) (No. 88-396). The Commissioner simply fails to recognize that the fundamental differences between indemnity reinsurance and assumption reinsurance are directly relevant to the income tax treatment of indemnity reinsurance ceding commissions.

As discussed above, indemnity reinsurance is the issuance of insurance coverage by one insurance company to another. Assumption reinsurance is the sale of part or all of the insurance policies of one insurance company to another. The basic and important difference between the two transactions was recognized by Congress when it enacted the 1959 Act. Thus, sections 806(a), 809(c)(1) and (d)(7), and 820 all provides rules which distinguish between indemnity and assumption reinsurance transactions.[14]

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the insurance business. As noted above, *supra* pp. 4-6, indemnity reinsurance is an integral part of the day-to-day business of the insurance industry. Indemnity reinsurance expenses are thus appropriately treated as ordinary and necessary expenses, even though each and every insurance company may not engage in indemnity reinsurance on a daily basis. *See generally Deputy v. Du Pont*, 308 U.S. 488, 495 (1940); *see also Equitable Life Ins. Co. of Iowa v. Commissioner*, 36 T.C.M. (CCH) 1184 (1977) (an insurance company's expenses incurred in registering variable annuity contracts are currently deductible day-to-day expenses of producing and marketing a business product).

[14] In addition, section 817(e) (repealed as "deadwood" in 1976, Pub. L. No. 94-455, § 1901(a)(100), 90 Stat. 1525, 1781) provided that if a company reinsured all of its contracts of a particular type

Furthermore, the Commissioner's own regulations acknowledge the distinction between indemnity reinsurance and assumption reinsurance in the context of the treatment of ceding commissions. The Commissioner's regulations do not provide that a ceding commission paid under an indemnity reinsurance contract is to be capitalized and amortized. However, Treas. Reg. § 1.817-4(d)(ii)(B), recognizing that assumption reinsurance is the sale of insurance contracts, requires "any amount paid to the reinsured [in an assumption reinsurance transaction] for the purchase of such contracts" to be capitalized and amortized.

Treas. Reg. § 1.817-4(d)(ii)(B) was issued on December 13, 1962, only three years after Congress enacted the 1959 Act. *See* T.D. 6225, 1963-1 C.B. 78. The regulation gives effect to the congressional recognition that an assumption reinsurance transaction involves the sale of some or all of an insurance company's contracts. It is a contemporaneous acknowledgment by the Commissioner that, unlike the ceding commission under an indemnity reinsurance contract, the consideration paid by the reinsurer in an assumption reinsurance transaction is for the purchase of insurance contracts. Accordingly, Treas. Reg. § 1.817-4(d)(ii)(B) requires that assumption reinsurance consideration be capitalized and amortized.

In addition, unlike the Courts of Appeals for the Fifth and Eighth Circuits,[15] the Courts of Appeals for the Sev-

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during 1958 "through the assumption by another company . . . of all liabilities under such contracts," the transaction was to be treated as a sale of a capital asset. This rule applied only to assumption reinsurance, not to indemnity reinsurance. *See* Treas. Reg. § 1.817-4(d). (Treas. Reg. § 1.817-4(d) clarified that although an assumption reinsurance contract was treated as a sale, the gain was not to be given capital gain treatment.)

[15] *See Colonial Am. Life Ins. Co.*, 843 F.2d 201; *Prairie States Life Ins. Co. v. United States*, 828 F.2d 1222 (8th Cir. 1987); *Modern Am. Ins. Co. v. Commissioner*, 818 F.2d 1386 (8th Cir. 1987).

enth and Ninth Circuits, as well as the Tax Court, have properly recognized the important distinctions between assumption reinsurance and indemnity reinsurance with respect to the treatment of ceding commissions. *Merit Life*, 853 F.2d 1435; *Oxford Life*, 790 F.2d 1370; *Beneficial Life*, 79 T.C. 627. As the Court of Appeals for the Seventh Circuit stated:

> The Court of Appeals for the Ninth Circuit recently distinguished assumption reinsurance from indemnity reinsurance with respect to the tax treatment of ceding commissions. *Oxford Life Insurance Company v. United States*, 790 F.2d 1370 (9th Cir. 1986). Although that case involved assumption reinsurance, the court emphasized its holding by making the following comparison between both reinsurance transactions:
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> > Assumption reinsurance transactions receive different treatment in the Tax Code from that accorded indemnity reinsurance transactions because of the transfer of assets. An assumption reinsurance transaction is treated as a sale of policies; an indemnity reinsurance transaction is the purchase of insurance protection [by] the reinsured. *Beneficial Life*, 79 T.C. at 645-46.
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> *Merit Life*, 853 F.2d at 1442.

In short, Congress intended that assumption reinsurance be treated differently than indemnity reinsurance, and the Code and regulations so provide. Indemnity reinsurance, including its initial expenses (ceding commissions), is treated under the Code and regulations in the same manner as directly written insurance. Assumption reinsurance, on the other hand, consistent with its nature, is treated as the purchase of assets.

IV. The Current Deductibility of Indemnity Reinsurance Ceding Commissions Is Vital to the Life Insurance Industry

Since 1958, life insurance companies have treated indemnity reinsurance ceding commissions as currently de-

ductible expenses for Federal income tax purposes.[16] This is the treatment that has been required since 1951 by the National Association of Insurance Commissioners for state regulatory accounting purposes. As the Court in *Merit Life* stated:

> [T]he Supreme Court has expressed a preference for the accounting rules and procedures of the National Association of Insurance [Commissioners] ("NAIC"). The Court has interpreted 26 U.S.C. § 818(a) as providing that the tax liability for insurance companies is to be computed consistent with the NAIC's rules except where "accrual accounting indicate[s] a contrary result, . . ." *Commissioner v. Standard Life and Accident Insurance Company*, 433 U.S. 148, 159, 97 S.Ct. 2523, 2529, 53 L.Ed.2d 653 (1977). Because generally accepted accounting principles (accrual accounting) do not control the tax treatment for ceding commissions in indemnity transactions, we must consider the NAIC's rules. Both parties agree that Merit's current deduction of ceding commissions followed the accounting rules for life insurance companies established by the NAIC.

Merit Life, 853 F.2d at 1444 (footnote omitted). Capitalization of ceding commissions would deviate from these traditional and Congressionally sanctioned accounting practices.[17]

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[16] Prior to 1958, life insurance companies were taxed only on their investment income, and therefore the treatment of ceding commissions was not relevant to determining life insurance companies' taxable income.

[17] The Commissioner has asserted that allowing the deduction of ceding commissions paid by an indemnity reinsurer causes "a gross distortion of income by mismatching the future income to be derived by a reinsurer from the reinsured policies with the current cost incurred to acquire the rights to that income." Brief for the Respondent on Petition for a Writ of Certiorari at 6, *supra* p. 21. Here again, the Commissioner fails to recognize that indemnity reinsurance is simply the issuance of an insurance policy by one insurance company to another. It is quite common for an insurance company issuing a policy to incur underwriting losses in the early years of the

Moreover, capitalization of indemnity reinsurance ceding commissions would disadvantage those companies which need indemnity reinsurance to survive or to grow. As one commentator has noted, reinsurance "is the only means by which a small, new company can compete effectively in the market place with its larger and better established brothers." *See* Rohm, *supra* p. 6, at 100. The obvious result of requiring capitalization of ceding commissions by indemnity reinsurers would be to increase the costs of indemnity reinsurance to direct writers. This would disproportionately hurt small and growing companies which, because of relatively low retention limits, must use significantly larger amounts of indemnity reinsurance in order to compete with the larger, more established companies in insuring new risks. These small and growing companies would be forced to reflect the increased cost of indemnity reinsurance in the premiums they charge policyholders, putting them at a competitive disadvantage vis-a-vis those companies for whom indemnity reinsurance is less crucial.

The marketplace should determine the competitive balance within the life insurance industry, and Federal income taxation should not disturb adherence to sound insurance practices requiring the use of indemnity reinsurance. This is only possible if the tax system is neutral as between the insurance company that uses indemnity reinsurance and the insurance company that does not use indemnity reinsurance. Neutrality requires, among other things, tax parity between the direct insurer and the indemnity reinsurer with respect to the deductibility of initial expenses, including ceding commissions. Congress

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policy. This occurs because the currently deductible expenses incurred in issuing the policy exceed the initial premium payments received. This fact has been specifically recognized by Congress and it has not been viewed as causing a "gross distortion of income." *See* H.R. Rep. No. 34, *supra* p. 14 note 8, at 4; S. Rep. No. 291, *supra* p. 14 note 8, at 7; *Merit Life*, 853 F.2d at 1443.

recognized this in section 809(c)(1) by providing that indemnity reinsurance ceding commissions are deductible when incurred just as the initial expenses of the direct writer are deductible when incurred.

CONCLUSION

For the reasons set forth above, this Court should reverse the judgment of the United States Court of Appeals for the Fifth Circuit.

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